AUDITORS' PERCEPTIONS OF FINANCIAL CONTROLLER BEHAVIOURS: THE EXISTENCE OF POSITIVITY AND NEGATIVITY BIASES

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DECEMBER 2010

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ABSTRACT

Client management forms part of a company's internal control environment. If management's honesty and competency are questionable, the audit evidence derived from its control system may also be questionable. The first study in this thesis consists of a survey that was administered to identify which factors auditors associate with the honesty and competency of client management. Factors associated with the honesty of client management are more likely to be associated with fraud risk, whereas factors associated with the competency of client management are more likely to be associated with error risk. In most cases, the auditors correctly identified the factors as being related to honesty vs competency. However, some of the fraud risk factors were classified as error risk factors. This will have impact on the scope of work of an audit. The second study is a behavioural experiment to examine the impact of client management behaviour on auditor's judgment. This is a 2 (initial honesty) x 2 (initial competency) x 2 (consistency of honesty) x 2 (consistency of competency) between-subjects design experiment. The survey in the first study serves as a means to determine what behaviours can best represent the operationalisations of honesty and competency in the experiment. The theories on impression formation particularly the category-diagnosticity theory underlie the manipulations of variables in the experiment. Both honesty and competency are tested simultaneously in the experiment. Previous studies have only examined honesty and competency in separate experiments. The findings for the experiment are not consistent for all audit assertions, and thus, there is not sufficient evidence to support the propositions in the category-diagnosticity theory. Thus, when both honesty and competency are being evaluated at the same time by auditors, their evaluation of one could have an impact on the other.

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CHAPTER ONE

INTRODUCTION

1.1 Introduction

Honesty and competency of management have been the highlights in the collapses of companies. The Australian Royal Commission, in its report on the collapse of HIH Insurance, states that the lack of integrity that existed in the company, combined with the lack of attention to detail and accountability, were the factors leading to poorly conceived business decisions that were poorly executed (Owen 2003). HIH Insurance is one example where management lacked integrity and competency; this is also not uncommon with other corporate collapses such as Enron, Worldcom and Onetel.

Management dishonesty and incompetency are the main factors of material misstatements in financial reports. Dishonest management may be tempted to perpetrate fraud when there is an incentive, opportunity and pressure to do so. For example, a company trying to attract investors in an initial public offer, or a company that is in the process of applying for loan, may be tempted to window-dress their financial reports in order to show good performance (Burns and Kedia 2006; Dechow et al. 1996; Efendi et al. 2007; Lie 2005). The competency of management also affects the quality of financial reports. If management is not competent, they may make bad decisions over accounting matters, which may result in materially misstated financial reports. In addition, managers who are not competent may make bad decisions with the poor results of those bad decisions being reflected in the financial report. This may put pressure on management to bias the accounts to cover up the effects of their bad business decisions. Therefore, audit client management characteristics are a factor that affects auditors' assessments of error risk (Goodwin 1999; Helliar et al. 1996; Monroe et al. 1993; Peecher 1996). As a consequence, auditing standards emphasise the need for auditors to assess the honesty[1] and competency of audit clients (ASA 240[2] and ASA 315[3]). However, little is known about how management integrity and competency affect auditor judgments. Studies examining client integrity find that auditors' judgments of client integrity are important in auditors' decision-making, for example, in acceptance of client decisions (Ayers and Kaplan 1998; Ayers and Kaplan 2003), however, very few studies examine the impact of management integrity and management competency on audit risk judgments (Beaulieu 2001; Kizirian et al. 2005).

1.2 Research Aims

This thesis has two aims. The first aim is to identify factors that affect auditors' perceptions of the honesty and competency of client management and find out how these factors affect their assessments of the risk of fraud and error. The first study in this thesis addresses this aim. A survey study is undertaken where auditors are

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[1] In the context of auditing standards this is also referred to as integrity.

[2] ASA 240 The Auditor's Responsibility Relating to Fraud in an Audit of Financial Report.

[3] ASA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment

presented with descriptions of client management behaviour. The auditors categorise the descriptions of audit client management behaviours into honesty or competency behaviours or neither. For each behaviour description, participants also assess the level of risk of fraud and error arising from the behaviour. Therefore, the first study provides information about how different client management behaviours affect auditors' perceptions of client management's honesty and competency and their effect on assessments of fraud risk and error risk.

The psychology literature reports that people exhibit positivity and negativity biases when forming impressions about the honesty and competency of people. Prior research finds that negative behaviours are more diagnostic than positive behaviour in people's judgement of honesty and positive behaviours are more diagnostic than negative behaviour in their judgment of competency (Klein 1991; Peeters and Czapinski 1990; Singh and Teoh 2000; Skowronski 2002; Skowronski and Carlston 1987; Vonk 1993). (Anderson and Marchant 1989) also find that auditors display the same biases as other people in that they are negatively biased in perceiving honesty and positively biased in perceiving competency. However, Anderson and Marchant (1989) do not examine whether such biases affect audit related judgments by auditors. Perceptions of the honesty and competency of client management should affect auditors' judgments and decision-making, particularly with respect to assessments of the risk of fraud and error in the financial report. Fraud and error assessments may be affected by the positivity and negativity biases reported in Anderson and Marchant (1989). Therefore, the second aim of this thesis is to examine the effect of biases in auditors' perceptions of honesty and competency of client management as reflected in their judgments when making risk assessments related to audit assertions. To achieve this, a behavioural experiment is conducted.

In the experiment, auditors read a case study on a hypothetical client, which includes information about the client's financial controller's behaviour that can be used to infer the honesty and competency of the financial controller. The findings from the first study are used to operationalise the honesty and competency variables in the behavioural experiment. After reading the information, the auditors make a set of assessments on whether several audit assertions are true or not true using a seven-point Likert scale. Next, more information about the financial controller's behaviour is provided. The additional information is either consistent or inconsistent with the initial information, i.e., if the initial information about the financial controller describes him as honest and competent, the second set of information describes him as honest or not honest and competent or not competent. After reading the additional information, the auditors make a second set of assessments on whether audit assertions are true or not true. Both sets of assessments and the revisions to the first assessments are used to examine the effect of the financial controller's honesty and competency on the auditors' judgements and to determine whether auditors exhibit a positivity bias for information relating to competency and a negativity bias for information relating to honesty, as reflected in the risk assessments.

1.3 Contributions

This thesis makes several significant contributions to our understanding of auditors' perceptions of the audit client management behaviours. The need to separately identify honesty and competency is magnified with the enforcement of an auditing standard that specifically requires auditors to consider fraud in the audit of financial statements (ASA 240). Its implementation in recent years warrants further research into the issue on whether auditors appropriately identify and distinguish honesty factors (which affect fraud risk) from competency factors (which affect error risk). The survey study is the first research that examines auditors' perceptions of client management behaviours that relate to honesty and competency of client management that directly relate to the work of an auditor. This method is similar to the method used by Anderson and Marchant (1989). However, they do not extend the effect of honesty and competency and the biases associated with perceptions of honesty and competency to auditor judgments such as fraud and error risk assessments.

1.3.1 Practical Contribution

The auditing literature reports that among the most important factors relating to management characteristics are error risk and fraud risk factors (Apostolou et al. 2001a; Heiman-Hoffman et al. 1996; Smith et al. 2005; Weisenborn and Norris 1997). However, not much is known on how auditors perceive such characteristics as displayed by the behaviours of the client management. The present study on auditors' perceptions of the behaviours of client management provides evidence on the impact of auditors' perceptions of client management behaviours signalling honesty and competency on auditors' judgments. The results may assist researchers in developing decision-making aids that take into consideration auditors' perceptions of management behaviour and enhance the accuracy of auditors' decisions without imposing additional cognitive costs. Further, it has been suggested that decomposing fraud risk assessments may require less cognitive effort in assessing fraud risk and may allow auditors to better process fraud risk factors (Wilks and Zimbelman 2004). Similarly, separately identifying the risk due to dishonesty from the risk due to incompetency may require less cognitive effort and lead to more accurate audit judgments.

Even though auditors are sensitive to the integrity and competency of management (Abdel-khalik et al. 1983; Beaulieu 2001; Brown 1983; Hirst 1994; Joyce and Biddle 1981b; Peecher 1996; Schneider 1984, 1985), prior research does not show how perceptive auditors are in recognising client behaviours that may be indicative of dishonesty and incompetency and how this impacts on risk assessments. Wrongly perceived behaviours may result in auditors planning to use inappropriate audit procedures. ASA 240 requires auditors to plan to conduct different audit procedures to detect material misstatements from fraud. Fraud detection procedures are supposed to be "forensic" in nature. Thus, a fraud risk factor related to the dishonesty of management that is wrongly classified as a competency factor and, therefore, an error risk factor, may lead to an ineffective audit. This thesis investigates whether auditors properly interpret the behaviours of client management as being related to honesty (related to fraud risk) and competency (related to error risk) and the effects of these behaviours on risk assessments.

1.3.2 Theoretical Contribution

Biases can distort auditors' judgments. Previous studies find that auditors are subject to biases such as a recency bias (Ahlawat 1999; Bamber et al. 1997; Brown 2009; Guiral and Esteo 2006) and a confirmation bias (Ashton and Ashton 1990; Kida 1984). Further, cue-diagnosticity theory (Skowronski and Carlston 1987) proposes that people are negatively biased in perceiving honesty and positively biased in perceiving competency. Auditors are professionals, who are required to exhibit professional scepticism when conducting an audit. As a result, they may be more objective in their perceptions of honesty and competency of their client management, and the negativity and positivity biases reported in the psychology literature may not extend to audit judgments and decision-making. Therefore, this thesis extends cue-diagnosticity theory by providing evidence on whether auditors act in the same manner as ordinary people in perceiving behaviours that signal honesty and competency and whether this impacts on their audit related judgments. This also enriches the literature on human behavioural studies.

1.4 Structure of the Thesis

This thesis is structured as follows. Chapter Two discusses the literature on audit risk in relation to the honesty and competency of audit client management. Chapter Three describes the survey study. Chapter Four discusses the belief revision model and cue-diagnosticity theory (Skowronski and Carlston 1987) and the hypotheses to be tested in the behavioural experiment. The belief revision model predicts that negative information has a greater effect than positive information on belief revision, while cue-diagnosticity theory predicts a negativity bias in perceptions of honesty and a positivity bias in perceptions of competency. Chapter Five describes the development of the case study used in the behavioural experiment. Chapter Six reports the results of the experiment that examine the propositions of belief revision model and cue-diagnosticity theory. The results presented in that chapter provide evidence on the existence or absence of biases in auditor's perceptions of honesty and competency behaviour of client management. Chapter Seven provides a summary and conclusions from the research findings. Some practical implications are also discussed. Finally, the chapter discusses the limitations and opportunities for future research from this research.

Related supplementary information is presented in the Appendices. Appendix 1 contains a list of probable honesty and competency behaviours, which are compiled from various sources, for example, actual cases, the auditing standards and previous research work. Appendix 2 contains the related documents and the questionnaire used in the survey study. The research instrument used in the behavioural experiment is presented in Appendix 3.

CHAPTER TWO

LITERATURE REVIEW ON AUDITORS' PERCEPTIONS OF CLIENT BEHAVIOUR

2.1 Introduction

Important factors in an entity's control environment are management's integrity and ethical values and their competency (COSO 1992). This chapter discusses the literature surrounding auditor's assessments of fraud risk and inherent risk. It relates the honesty of audit client management with fraud risk and their competency with error risk, which form the basis of my survey.

The next section discusses honesty and fraud risk assessment followed by a discussion of competency and error risk assessment in Section 2.2. A conclusion is drawn in Section 2.3.

2.2 Honesty and Fraud Risk Assessment

Behavioural dimensions of an individual, such as honesty, form the characteristics or attitudes of that individual. Management's incentives and abilities to manipulate account balances are manifestations of their attitudes and moral reasoning. Given an opportunity to commit fraud, a dishonest manager may take advantage of a situation providing an opportunity for fraud, but an honest manager would not.

Auditing standards are unambiguous in stating that fraud risk is one of the risks that require consideration by auditors (AuASB 2009b). ASA 240 (AuASB 2006) defines fraud as involving the use of deception to obtain an unjust or illegal advantage. Thus, an act that is legal but unjust, for example, not giving full disclosure of a takeover with the intention of concealing significant information from the shareholders that may jeopardise their interests, is considered a fraudulent act. ASA 240 (AuASB 2006) requires auditors to identify fraud risk factors that may indicate that fraud exists in a client entity. Auditors should react to fraud risk factors by assessing the levels of risk accordingly and planning and conducting audit procedures to ensure that material misstatements due to fraud can be identified.

Fraud involves deception. In a fraudulent action, there is an element of intentional false representation, which is acted upon the victim to the victim's damage (Albrecht et al. 2006). Traditional fraud theory states that there are three conditions that must exist if fraud is to occur (Cressey 1953), which are now popularly known as the Fraud Triangle (Albrecht et al. 2006). The first condition is pressure (or motivation) to commit fraud, where a fraud perpetrator may have pressure to commit fraud. For example, a manager has pressure to show good performance if his bonus is tied to the firm's performance. Such behaviour has been observed by a few studies. Dechow et al. (1996) find that management is motivated to manipulate earnings when a firm is trying to attract external financing at a low cost as stock options are also associated with incentives to misreport earnings (Burns and Kedia 2006; Efendi et al. 2007; Lie 2005). Similarly, misstatements are more likely to occur in firms that are constrained by debt covenants, or firms raising new debt or equity capital (Efendi et al. 2007) and firms may be motivated to window-dress their accounts in such circumstances to portray good performance.

The second condition is the existence of an opportunity to commit fraud, for example, a poor corporate governance structure. Corporate governance has been recognised as one of the controls to address the risk of management override, where a higher incidence of fraud is partly due to greater opportunities associated with a poor governance structure (Hogan et al. 2008). Studies on corporate governance find an association between corporate governance practices and occurrences of fraudulent acts in firms. Prior research finds that firms with manipulated earnings are those that have less independent boards (Beasley 1996; Dechow et al. 1996; Farber 2005; Lo et al. 2010; McMullen and Raghunandan 1996; Osma 2008). This is consistent with the findings that independent corporate boards provide effective monitoring of earnings management (Jaggi et al. 2009). In addition, firms that manipulate earnings tend to have the same person as chairman and CEO (Dechow et al. 1996), and where the CEO is the founder or chairman (Dechow et al. 1996; Farber 2005). Dominant management is one of the primary factors that increase the opportunity for fraud (Loebbecke et al. 1989). Audit committee characteristics also have an impact on the likelihood of financial statements being restated where higher occurrences of fraudulent acts are associated with firms: not having an audit committee (Dechow et al. 1996); fewer audit committee meetings (Farber 2005); having fewer financial experts on the audit committee (Abbott et al. 2004; Farber 2005); and where the audit committee is less independent and less active (Abbott et al. 2004).

The third condition is rationalisation by the perpetrator committing the fraud. Fraud will not be committed if the perpetrator is unable to justify his fraudulent act. Management may rationalise that any behaviour that creates advantage for the firm in a competitive environment is tolerable and encouraged even though the act may create a disadvantage for the competition. Some of the common rationalisations for smaller business concerns are: owners to bend the rules a little in order to be successful; or they are unfairly disadvantaged due to their size and thus, compromising ethical standards is considered acceptable behaviour; or an unethical decision is taken as a short-term solution to develop the business (Jackson et al. 2010). However, Sitorus and Scott (2008) find that rationalisation does not have a direct influence on "fraud commission". Nevertheless, incidents of fraud appear to be higher when employee perceptions of organizational justice are poor (Rae and Subramaniam 2008) and thus, such an employee may justify their fraudulent actions

Management may resort to lying to rationalise their actions.[4] Lying may be accelerated where the environment created by the top executives is conducive to dishonesty. While management might think that it is necessary for them to be selective in telling the truth, which could be due to possible disadvantages or damage the truth could bring to the firm, this may lead to more lies to cover up the initial

[4] It is common in the business environment to lie and hope to get away with it (Williams 2009) even though it is thought to be bad in the business environment.

lie(s). The extent to which management lies depends on the type of individuals they are. They could be classified as ethical individuals who are fully honest or economic individuals who are willing to lie to maximise wealth (Koford and Penno 1992). An ethical manager will not lie, whereas an economic individual tells lies necessary to maximise their wealth when they experience no disutility from lying (Gneezy 2005). A manager falls in a category somewhere along this continuum.

There are individuals who weigh the gains and losses from behaving unethically. (Williams et al. 2009) find that unselfishness diminishes as potential gain increases. This is consistent with the linkage between ethical ideology and decision-making (Callanan et al. 2010). Callanan et al. (2010) find that there is a greater likelihood that an unethical option will be chosen when participants perceive higher personal benefit. Similarly, there is a greater likelihood that participants scoring low on idealism will choose an unethical option when there is a lower perceived chance of getting caught. Further, more ethical options are chosen when the perceived opportunity to commit the unethical act is low and when the perceived chance of getting caught is high. Their study illustrates the connection between honesty and portrayal of behaviour. Thus, it is possible to auditors to foresee potential fraud by observing the behaviour of client management. Auditors observing management's low idealism should be cautious as they may be more likely to make unethical business decisions than management with high idealism.

However, such rationalisation can be attributed to the level of ethics promoted by the firm's environment. The tone at the top should be one that creates a general feeling of honesty and integrity that pervades throughout the organisation. The integrity of top management is one of the most important factors to consider when assessing the risk of material misstatement in financial statements. The strength of the internal control system and the economic condition of the client entity are the other major determinants of incidents of material misstatements in the accounting process (Warren 1979). Management who lack integrity have a tendency to override or circumvent controls (Dirsmith and Haskins 1991; Messier and Austen 2000b; Shailer et al. 1998). Unethical management is actually sending a message to employees that fraudulent or unethical conduct may be considered acceptable by the firm (Kenyon 2009). Thus, if there exists in the firm, pressure and opportunity to commit fraud, an honest manager (or employee) will choose not to rationalise any unethical or fraudulent behaviour. Rationalisation to commit fraud seems to be the most important element in the fraud triangle that determines whether a manager or employee will commit fraud. Dishonesty makes it easier to rationalise, requiring less perceived opportunity or pressure for fraud to be committed. Thus, central to the issue of fraud occurrence is honesty.

Very few fraud cases are discovered by auditors. Joseph T. Wells, the Chairman of the Association of Certified Fraud Examiners (ACFE), stated in an interview that audits have detected very few fraud cases (fewer than 5% of the fraud in an ACFE's study[5]) because the clues to fraud are largely behavioural and not necessarily financial in nature (Nilsen 2010). Therefore, auditors should pay attention to both financial and behavioural cues when assessing fraud risk.

In their effort to promote ethical behaviour in firms, governments emphasise the importance of ethical conduct by management. The United Kingdom (UK) Government appointed the Cadbury Committee, which proposed the Code of Best practice (known as the Cadbury Code) in 1992. Since then, there have been many up-dates of the code and the most recent is the UK Corporate Governance Code, which was issued in June 2010. The US Government enacted the Sarbanes-Oxley Act of 2002, which imposed a dramatic change on the corporate governance practices of firms. This led to the development of codes of ethics for financial officers and also employees (Canary and Jennings 2008). Among the requirements is management's honest and ethical conduct, including the ethical handling of conflicts of interests. The Act also requires firms to disclose their code of practice in their annual report. In Australia, the Australian Securities Exchange (ASX) Corporate Governance Council issued the Principles of Good Corporate Governance Practice and Best Practice Recommendations in 2003, which was revised in 2007, as guidelines for firms to promote ethical conduct among their managers and employees.[6]

[5] Findings were reported in the 2010 Report to the Nations on Occupational Fraud and Abuse, which can be accessed at acfe.com/rttn.

[6] The eight principles laid down by the council are: (1) Lay solid foundations for management and oversight; (2) Structure the board to add value; (3) Promote ethical and responsible decision-making; (4) Safeguard integrity in financial reporting; (5) Make timely and balanced disclosure; (6) Respect the rights of shareholders; (7) Recognise and manage risk; and (8) Remunerate fairly and responsibly (ASXCGC 2007).

Despite these efforts by governments, fraud is still on the rise. The Association of Certified Fraud (ACFE) reported that losses due to fraud, in terms of the US Gross Domestic Product, rose from $600 billion in 2002 to $994 billion in 2008 (ACFE, Report to the Nation, 2002, 2004, 2006, 2008). One may deduce that it is perhaps the greed and dishonesty of those who hold power in the firms that drive these fraudulent acts.

Studies on audit risk assessment, particularly in relation to fraud risk, show that auditors acknowledge the importance of management integrity in their assessments of audit risk, where it is found that the integrity of the audit client's management influences auditors' risk assessments (Allen et al. 2006; Apostolou et al. 2001b; Ayers and Kaplan 2003; Beaulieu 2001; Iyer and Reckers 2007; Joyce and Biddle 1981a, b; Kizirian et al. 2005). In particular, the integrity of client management impacts on auditors' decisions on the acceptance of client (Ethridge et al. 2007; Peecher 1996), materiality estimates (Arnold et al. 2001; Bernardi and Arnold 1994; Friedberg et al. 1989), fraud detection (Bernardi 1994), likelihood of assessments of account overstatement and required write-downs (Goodwin 1999), and the discovery of misstatements (Kizirian et al. 2005). Auditors also adjust their risk assessments in relation to their client's reputation and, accordingly, amend their audit procedures (Ayers and Kaplan 2003; Beaulieu 2001; Johnstone 2000).

Several studies rank the importance of the fraud risk factors in order to investigate which factors are weighted as the most important ones (Apostolou et al. 2001b; Heiman-Hofman et al. 1996; Smith et al. 2005; Weisenborn and Norris 1997). These studies find that management characteristics are the most important fraud risk factors and management's failure to display appropriate attitude about internal control is one of the most important individual factors.

Studies investigate ways to effectively detect fraud. (Zimbelman 1997) finds that when risks are "decomposed" during the risk assessment as opposed to a universal assessment of the risk of material misstatements from both error and fraud, auditors' sensitivity to fraud risk factors that may be indicative of a material misstatement increase.[7] Separate assessments and separate documentation of fraud risk increase auditors' attention to fraud risk cues. Therefore, fraud risk assessments are enhanced by considering fraud risk separately from misstatements due to error even though fraud risk factors may be difficult to interpret, measure and weigh (Allen et al. 2006).

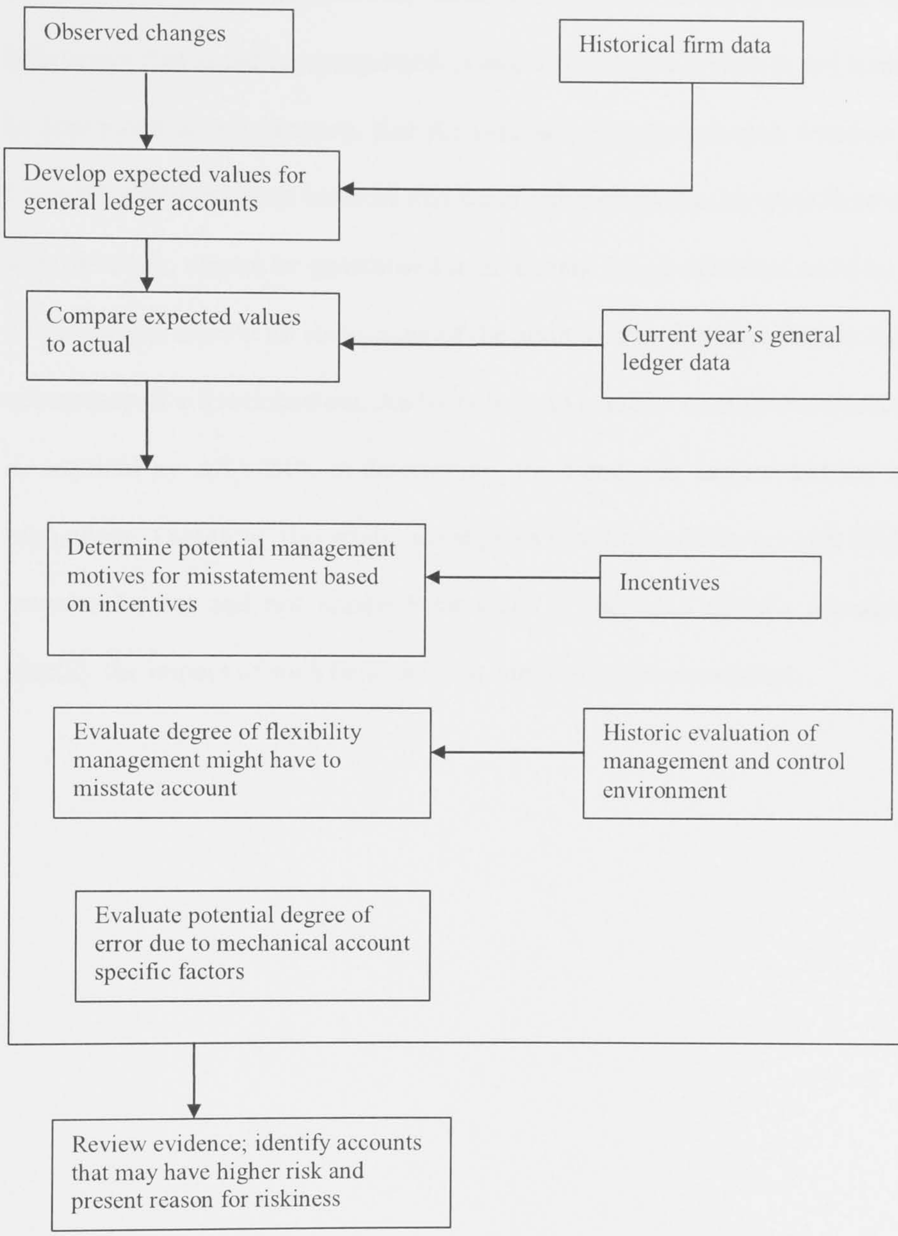
Studies also integrate fraud risk factors into fraud prediction models. Apostolou, Hassell and Webber (2001) develop a decision model to rank fraud risk factors. Bell and Carcello (2000) develop a logistic regression model that includes fraud risk factors as independent variables. They use 382 actual fraud and non-fraud cases to identify the risk factors they include as variables and their "best" model includes: weak internal control environment; management lies to auditors or are overly evasive; and an interaction between weak internal control environment and aggressive management attitude toward financial reporting. Both studies find that management characteristics are one of the most important factors.

[7] This is also a requirement under SAS 99 Consideration of Fraud in a Financial Statement Audit AICPA. 2002. "Consideration of Fraud in a Financial Statement Audit." In SAS 99.

In developing a computational model to make more accurate audit risk assessments, Peters et al. (1989) develop a conceptual model of inherent risk evaluation. This model is reproduced in Figure 2.1. In this model, management's incentives and abilities to manipulate account balances are depicted as crucial in assessing inherent risk.

Risk assessments should be an ongoing process as required by ASA 500 whereby understanding the client firm and its environment, including its internal control, is a continuous, dynamic process of gathering, updating and analysing information throughout the audit. Therefore, auditor's assessments of the integrity of management should be updated throughout the audit (Kizirian et al. 2005).

Figure 2.1
Conceptual Model of Inherent Risk Evaluation
(Source: Peters, Lewis and Dhar, 1989)



All of these studies find that management characteristics, which include the honesty of client management, affect auditors' assessments of risks, particularly their assessment of fraud risk. However, these studies do not actually illustrate the types of behaviours that could be categorised as behaviour that is honest or not honest. It may be concluded at this juncture, that the findings are quite general, whereas ASA 240 (AuASB 2006) cautions auditors that fraud risk factors can be specific to each client and, therefore, cannot be generalised to all clients. It is crucial that auditors are aware of such behaviours at an early stage of the audit so that they can foresee the potential occurrence of a fraudulent act. Auditors have to exercise their professional judgment, as required by ASA 240, in determining the fraud risk factors that are specific to each client. Therefore, this study investigates whether auditors are able to distinguish between honest and not honest behaviours of the audit client's management and identify the impact of such behaviour on auditors' risk assessments.

2.3 Competency and Audit Risk Assessment

Competency is the quality that a person possesses of being suitably qualified physically and intellectually. A competent manager should perform effectively and efficiently and thus, the level of risk due to error (or inherent risk) may be set at a low level. Management makes up the control environment of an organisation and thus, the assessment of control risk must always include consideration of the control environment. The assessment of both inherent and control risk requires a high degree of audit professional judgment. If management is indifferent to the importance of controls then, no matter how effective the system might appear to be, control risk must be assessed higher than another system where the control environment is strong.

Audit risk can be defined as auditor's willingness to accept that the financial statements may contain material misstatements after the audit is completed and auditor issues a clean audit report. The audit risk model is usually expressed as follows:

$$AR = IR \times CR \times DR$$

where;

AR = audit risk or the risk that the auditor issues a clean audit opinion when the financial statements contain material misstatements.

IR = inherent risk or the likelihood that there are material misstatements in a financial report before considering the effectiveness of the internal control structure.

CR = Control risk is the likelihood that misstatements exceeding a tolerable amount will not be prevented or detected by the client's internal control structure.

DR = detection risk or the risk that the auditor will not detect a material misstatement.

Both inherent risk and control risk are affected by the client's environment, which include factors relating to the client's management. Thus, incompetent management contributes to inherent risk.

In the US, the Sarbanes-Oxley Act (SOX) of 2004 requires auditors to perform a joint audit of the financial statements and the environment elements that include consideration of the quality and competency of the board of directors (Langmead and Michenzi 2010). This is consistent with ASA 315 (AuASB 2009b), which requires auditors to consider management's commitment to competence because employing incompetent people increases the possibility of misstatements in the financial statements due to errors. Client management and employees are among the components that make up the control environment of the client and the efficiency and effectiveness of internal control systems are also affected by the characteristics of employees or management because one of the five components of internal control is the control environment.[8] Corporate management has the responsibility of ensuring that the internal control system operates effectively and efficiently. If an auditor has concerns about the competency of the client's management, this should affect auditors' assessments of inherent risk and control risk.

Several studies find that characteristics of client management are factors linked to the presence of errors (Brumfield et al. 1983; Houghton and Fogarty 1991; Hylas and Ashton 1982; Kinney 1989). Management characteristics are perceived as the most important factors that influence inherent risk assessments at the financial statement level (Hellier et al. 1996; Monroe et al. 1993). Competency of client management is one of the factors that auditors consider when planning the audit (Abdel-khalik et al. 1983; Brown 1983; Goodwin 1999; Hirst 1994; Joyce and Biddle 1981a; Peecher 1996; Schneider 1984, 1985). Management is a source of information and, therefore, information obtained from more competent sources are considered as more diagnostic and affect the work of auditors more than information obtained from less competent sources (Goodwin 1999; Hirst 1994).

Schneider (1984 and 1985), Margheim (1986) and Suwaidin and Qasim (2010) find that the competency and work performance of internal auditors are perceived as almost equally important in an auditor's decision on whether to rely on the work of internal auditors. The auditing literature also reports that, not only are auditors

[8] The other four components are entity's risk assessment process; information system; control activities; and monitoring of controls (ASA 315).

sensitive to the competency of a source of audit evidence, they are also sensitive to the competency of their team members (Bamber 1983).

Characteristics pertaining to top management and the board of directors, are among the important inherent risk factors (Colbert 1987). Gibbins and Wolf (1982), using a questionnaire, identify items thought to be predictors of whether significant problems would be encountered for a hypothetical audit. Auditors choose from these items and are allowed to add their own items. They identify two classifications, client factors and audit firm factors, where the competency of client's top management is one of the significant client factors. Research also shows that higher risks are linked with high turnover in key personnel (Brumfield et al. 1983) as high turnover means that inexperienced employees are performing the task. Thus, it is appropriate to assess higher inherent risk when management turnover is high.

The competency of the client's staff responsible for or involved in the accounting process must also be considered when conducting an audit (ASA 240, ASA 315, ASA 500). Consistent with this requirement, Colbert (1988) finds that the quality of personnel in inventory calculation is the most important factor in influencing auditors' assessments of inherent risk as auditors consider it more important than factors such as controller turnover, financing pressure, and the complexity of inventory overhead. Another example is where accounting and financial staff do not have sufficient depth and experience to evaluate whether the application of complex accounting standards is appropriate, such as accounting standards for derivatives and hedges, and tax effect accounting. This leads to reliance on the external auditor to make the interpretations, which, in turn, may violate the auditor's independence (Langmead and Michenzi 2010). Houghton and Fogarty (1991) find that inherent risk factors such as non-systematic transactions have a higher likelihood of error. Some non-systematic transactions are normal recurring transactions and others are unusual transactions, which are not routine transactions that occur frequently and are not processed using routine processing procedures. These are normally accomplished by recording a journal entry. Unusual transactions are expected to have a high probability of error because routine processing procedures do not exist for such transactions.

In addition, management-related elements affect auditors' assessments of inherent risk, such as the quality of personnel in the accounting system (Colbert 1987, 1988; Messier and Austen 2000b); and past performance of management (Peters et al. 1989). Management having knowledge about their industry is also a condition for competency. In auditing the client's internal control environment, auditors must consider whether the client's management possess such knowledge. Studies find that management knowledge about changes in the industry and management's incentives influence auditor's assessments of inherent risk (Peters et al. 1989).

Therefore, in assessing inherent risk and control risk, the attitude or behaviour of client management should be among the issues considered by auditors. Related studies find that the competency of an audit client's management has an impact on audit work, where auditors consider it to be an important element from the internal control environment and it is considered by auditors when making audit risk assessments. However, these studies do not show how specific behaviours affect auditor's risk assessments. Therefore, this study investigates whether auditors are able to distinguish between competent and not competent behaviours of the audit client's management and identify the impact of such behaviours on their fraud and error risk assessments.

2.4 Conclusion

When assessing the risk of fraud and error in the client's financial statements, auditors need to consider the integrity and ethical values of client management and management's commitment to competence. Prior research finds that auditors consider the behaviour of client management when assessing audit risk. However, research investigating whether auditors distinguish between behaviours indicative of honest vs. not honest behaviour and those that indicate competent vs. not competent behaviour has not been conducted. The first study in this thesis investigates which client management behaviours auditors perceive as being indicative of honesty and competency and auditors' perceptions about whether these behaviours contribute to low or high risk of fraud or error in the financial statements.

CHAPTER THREE

STUDY 1: A SURVEY TO IDENTIFY CLIENT MANAGEMENT BEHAVIOURS INDICATIVE OF HONESTY AND COMPETENCY AND THEIR IMPACT ON FRAUD AND ERROR RISK

3.1 Introduction

Auditing standards require auditors to consider the competency and integrity (honesty) of audit client personnel. However, little is known about what auditors consider to be honesty and competency cues. Therefore, this study uses a survey to identify cues that are considered by auditors to signal the honesty and competency of client management. A survey is suitable to identify which behaviours auditors consider as honest (or not honest) and competent (or not competent) behaviours.

The results of the survey show that auditors classify client behaviour into honesty and competency behaviours and these perceptions are, in general, appropriately reflected in their assessments of risks. However, the results also indicate that, in some circumstances, auditors identify honesty factors as competency factors. In other words, some items that are indicative of fraud risk are considered as indicative of error risk. From a practical point of view, such perceptions may lead to incorrect assessments of fraud risk and error risk. In circumstances where auditors consider fraud risk to be high, they need to plan to use auditing procedures that are forensic in nature to discover the fraud. However, in circumstances where they consider error risk to be high, they are required to plan the use of auditing procedures with the objective to discover those errors. Forensic procedures are often quite different than procedures to detect errors. Therefore, incorrect perceptions of management's behaviour may have serious implications for the effectiveness of an audit.

This chapter is organised as follows: the following section explains the survey instrument and its administration, Section 3.3 discusses the results from the survey, Section 3.4 explains the limitations of this study. The conclusions from this survey are presented in Section 3.5.

3.2 The Survey

The objective of the survey is to identify factors that affect auditors' perceptions of the honesty or competency of client management. The survey contains 48 items, which are based on Appendix 3 of ASA 240, actual and fictitious fraud cases from the academic literature (Ballou and Mueller 2005; Boockholdt 2000; Keim and Grant 2003; Ragothaman et al. 2003; Strand et al. 2002; Zekany et al. 2004), and the AICPA's (American Institute of Certified Public Accountants) website on Ethics and Business Fraud (http://fvs.aicpa.org/Resources/ Antifraud+Forensic+Accounting/).

The actual fraud cases from the literature are Comptronix Inc (Boockholdt 2000); and Worldcom (Zekany et al. 2004). Comptronix Inc was founded in 1984 and was a high-technology company. Three of its founders became senior officers of the company. The company provided contract manufacturing services to equipment manufacturers in the electronics industry as their primary product was circuit boards for personal computers and medical equipment. Comptronix employed about 1,800 people in three operating locations. It went public in 1989, listing its stock with NASDAQ. It grew rapidly and consistently received "buy" recommendations from brokerage firms until fraud was suspected in 1992 when its board of directors disclosed that its earnings for 1989-1991 had been overstated and the Securities and Exchange Commission's (SEC) investigation determined that Comptronix's chief executive officer (CEO), chief operating officer (COO), and controller/treasurer colluded to overstate assets and profits by recording fictitious transactions. The three executives overrode existing internal controls so that others at Comptronix would not discover the scheme.

WorldCom was the largest accounting fraud in American history. It was a large telecommunication company that achieved its position as a significant player in the telecommunications industry through 65 acquisitions. Between 1991 and 1997, WorldCom spent almost $60 billion in the acquisition of many of these companies and accumulated $41 billion in debt. In preparing their financial statements, WorldCom used a liberal interpretation of accounting rules. In July 2002, WorldCom filed for bankruptcy protection after several disclosures regarding accounting irregularities. Among them was the admission of improperly accounting for operating expenses as capital expenditure in violation of generally accepted accounting practices (GAAP). WorldCom admitted to a $9 billion earnings adjustment for the period from 1999 through the first quarter of 2002.

In addition to actual fraud cases, fictitious cases are also considered so as to identify items that may be indicative of fraudulent acts and incompetence of staff and management of the audit client. Even though these are fictitious cases, the events in the cases are based on actual events in real organisations. All the articles from which the items are extracted are published in the Issues in Accounting Education Journal (Ballou and Mueller 2005; Keim and Grant 2003; Ragothaman et al. 2003; Strand et al. 2002). I consider it appropriate to adapt the circumstances from these cases because they are developed for the purpose of developing skills to identify fraud. In addition, some items are extracted from Monroe et al. (1993), who investigate auditors' perceptions of the importance of inherent risk factors in assessing inherent risk for accounts receivable and inventory. Their questionnaire lists 42 inherent risk factors and six control risk factors and the auditor participants are required to identify whether each factor is an inherent risk factor. They indicate whether the factor affects their assessment of inherent risk at the financial statement or account balance level.

Some of the items included in the survey are extracted from Appendix 3 of ASA 240, which contains examples of circumstances that indicate potential fraud. The circumstances include discrepancies in the accounting records, conflicting or missing evidence, and problematic or unusual relationships between the auditor and management. However, not all of these are included in the survey. Only those items associated with the behaviour of management are included.

The AICPA's series on Ethics and Business Fraud is another resource from which the items are extracted. These are suitable as they are used as case studies for training auditors.

From a review of these sources, a list of 76 items was generated. These items and their sources are shown in Appendix 1. A draft of the questionnaire consisting of the 76 items was given to six colleagues at the School of Accounting and Business Information Systems at the Australian National University to complete and for comment. Based on their responses and the feedback received, adjustments were made to the questionnaire. Some of the items were found to be similar, e.g., *"...adjustments showing reduction in operating expenses and increase in inventory on monthly basis but no documentations exist to support these adjustments"* (Item 2) is similar to "*There are frequent changes to the accounting estimates which are not accompanied by changes in circumstances"* (Item 61). As a result, item 2 is included in the final list but not item 61. In addition, the scores given were considered and items allocated the highest were considered to be unambiguous in representing the honesty and competency of client and thus, are included in the final list of 48 items in the questionnaire.

The final instrument is presented in Appendix 2. The survey instrument has three sections: (1) instructions; (2) a list of 48 items that the participants classify as indicative of honesty or competency and assess the level of risk associated with each item; and (3) questions capturing demographic information. Participants were informed of the objective, purpose of the survey and that the survey should not take more than thirty minutes to complete. They were then informed on how to answer the questions in the survey in Part 1 of the questionnaire.

An example of the questions that respondents have to answer is shown in Exhibit 3.1. For each of the items presented, the participants are asked to specify whether the item indicates honesty (H) or competency (C) of the auditee. A neither column (N) is also provided to avoid forcing respondents to classify any of the items into the two categories, when they perceive it as neither honest nor competent behaviour. They indicate their response by circling H, or C, or N and, they indicate whether they believe the item contributes to low or high risk of fraud or error in the financial statements by circling a number on a seven-point Likert scale. A "1" indicates the lowest risk while "7" indicates the highest risk of fraud or error.

Exhibit 3.1
Classification of Circumstances and Assessments of Risks

(a)

Does the circumstance indicate honesty or competency of the auditee? (Circle either H or C or N)		
Honesty	Competency	Neither
H	C	N

(b)

Does the circumstance contribute to low or high risk of fraud or error in the financial statements? (Circle the appropriate number).						
Low Risk						High Risk
1	2	3	4	5	6	7

When participants circle "H" to indicate the circumstance is an Honesty item in (a), the risk assessed in (b) is assumed to be a fraud risk factor due to the (dis)honesty of the client's management, and when they answer Competency in (a), the risk assessed in (b) is assumed to be an error risk factor due to the (in)competency of the client's management. If the answer is Neither, the risk is categorised as an error risk factor. Finally, the participants provide demographic information in Part 2.

3.3 Results

One hundred and five questionnaires were completed by auditors attending an audit training course in Adelaide, Brisbane, Melbourne and Sydney. In addition, 135 questionnaires were mailed to auditors having experience of five years or more. Their mailing addresses were obtained from the Australian Securities and Investments Commission's (ASIC) list of registered company auditors. Thirty-three responses were received from the mailed questionnaires giving a response rate of 24.4% for this group of auditors. In total, 138 usable responses were received.

Table 3.1 shows the demographic data of the participants. The respondents' audit experience ranges from 1 to 46 years, with a mean of 5.87 years. One respondent did not state his length of experience. The majority (61.6%) of the respondents are staff auditors in audit firms: 14.5% are senior auditors; 15.9% are audit managers; 2.2% are audit partners and 2.9% are internal auditors. The "other" category consists of sole practitioners and accountants, who have some experience in audit. The majority of the participants (77.3%) work for a Big-4 firm.

Table 3.1
Demographic Information of the Participants

	Auditors	**%**
n	138	100
Gender: M	79	55.1
F	62	44.9
Experience (years):		
Minimum	1	
Maximum	46	
Mean	5.87	
	(sd = 0.748)	
Current Post:		
Audit staff	85	61.6
Senior auditor	20	14.5
Audit manager	22	15.9
Audit partner	3	2.2
Internal auditor	4	2.9
Other	4	2.9
Firm Type:		
Big-4	106	77.3
Medium	13	9.4
Small	14	10.3
Other	4	2.9

The percentage for each item classified as H, C, and N is calculated. An item is classified as indicative of honesty when the percentage is the highest for H; it is classified as indicative of competency when the percentage is the highest for C; and as neither honesty nor competency when the percentage is the highest for N. Chi-square values (χ^2) are calculated for each of the items. Chi-square tests are used to analyse whether distributions of the categorical variables, namely H, C, and N, differ from one another. A significant χ^2 value means that the difference between these categories are real and not due to sampling error.

The following sections discuss the results of auditors' perceptions on the honesty and competency of the client management and their risk assessments.

3.3.1 Honest (or Not Honest) Behaviour of Client Management

Out of the 48 items, 15 are perceived as indicating honest (or not honest) behaviour. Table 3.2 shows the items perceived as indicating "Honesty". All but two of the items are significant at the $p < 0.001$ level. The last column of Table 3.2 shows the average assessment of each item's contribution to risk. A high risk value means the item indicates behaviour that is not honest and a low risk value means the item indicates honest behaviour. Items are arranged from the highest contribution to risk to the lowest contribution. The first 13 items have average assessments of 4.00 or higher.

Table 3.2
Items Perceived as Honest (or Not Honest) Behaviour and Their Contribution to Risk

Item No.	Item	Frequency, %			χ^2 value	Assessment of Contribution to Risk
		H	C	N		Mean (SD)
28.	The financial director gives an instruction to delete valid accounts payable two months before the year end and reinstate them around middle of the financial year.	64.96	5.84	29.20	72.89**	6.09 (0.087)
11.	A significant amount of physical inventory is missing.	46.62	19.55	33.83	14.63**	5.94 (0.087)
5.	The CEO terminated the vice president and a director who questioned the CEO's action to capitalise start-up costs with the intention to maintain or increase the stock price and earnings.	59.56	8.09	32.35	54.10**	5.66 (0.102)
39.	Management approves non-related expenses (e.g., personal travelling expenses) as a company expenses.	61.31	12.41	26.28	52.22**	5.38 (0.094)
4.	Individuals related to the directors sell their shares in a subsidiary before the subsidiary was sold.	64.96	2.92	32.12	79.20**	5.36 (0.127)
2.	There have been adjustments showing a reduction in operating expenses and an increase in inventory on a monthly basis but no documentation exists to support these.	41.30	25.36	33.33	0.07	5.36 (0.094)
23.	The sales manager sometimes made adjustments to the amounts of credit sales in writing on some of the carbon copies of sales vouchers.	54.07	14.07	31.85	32.53**	5.13 (0.095)
3.	There have been regular instructions from the chief accountant to transfer inventory to the equipment account.	42.96	22.22	34.81	54.41**	5.08 (0.113)
18.	Invoices payable to a particular supplier have not been processed in the usual manner.	46.62	24.81	28.57	10.84*	4.96 (0.110)
16.	The purchasing manager changed suppliers to the one who appeared to be a good friend of his.	65.94	3.62	30.43	80.91**	4.73 (0.102)
6.	The directors engage companies that they (and their families) own to do work for the company, for example, interior decoration service.	48.15	5.19	46.67	48.18**	4.65 (0.117)
35.	A director gives an expensive gift to a third party in the process of negotiating a contract.	54.41	5.15	40.44	52.60**	4.58 (0.125)
7.	A director is being investigated by the Australian Tax Office for allegedly reporting significantly less personal income.	65.69	2.92	31.39	81.21**	4.25 (0.158)
19.	The CFO confided to you that he entered the country as an illegal immigrant and asked you to keep this in confidence.	62.04	1.46	36.50	76.04**	3.77 (0.170)
38.	The financial controller tells the auditor his concern about a weakness in the control system.	66.42	23.36	10.22	71.05**	3.72 (0.138)
	*significant at $p < 0.01$ **significant at $p < 0.001$					

Items 11, 23, and 38 come from ASA 240. Items 11, and 23 are correctly perceived as acts that are not honest ($p < 0.001$ for both) and contribute to a high risk of fraud. The missing inventory in Item 11 (*A significant amount of physical inventory is missing*) is perceived as a result of dishonesty, as intended by ASA 240 and its contribution to fraud risk is high (mean = 5.94). The auditors correctly perceive Item 23 (*The sales manager sometimes made adjustments to the amounts of credit sales in writing on some of the carbon copies of sales vouchers*) as a fraud indicator as per ASA 240 and its contribution to fraud risk is high (mean = 5.13). The auditors relate these acts to dishonesty of client management and appropriately assess their effect on fraud risk as high. Missing inventory is associated with theft and making adjustments may indicate an act that is not honest. Hence, they are appropriately perceived as fraud risk indicators. Item 38 (*The financial controller tells the auditor his concern about a weakness in the control system*) is seen as an honest act by the financial controller because the contribution to fraud risk is moderate (mean = 3.72). This moderate (instead of low) level of contribution to risk could be due to the fact that the participants take into consideration the weakness that exists in the control system.

Items 28, 5, 4, 2, 3, and 7 are also significant ($p < 0.001$). These items come from an actual fraud case, Comptronix Inc in the US (Boockholdt 2000) and the participants appropriately perceive these as behaviours that are not honest. Item 28 (*The financial director gives an instruction to delete valid accounts payable two months before the year end and reinstate them around middle of the financial year*), Item 5 (*The CEO terminated the vice president and a director who questioned the CEO's action to capitalise start-up costs with the intention to maintain or increase the stock price and* *earnings*), and Item 3 (*There have been regular instructions from the chief accountant to transfer inventory to the equipment account*) involve manipulation of the accounts that have been instructed by higher level of management within a firm. It is obvious that these circumstances would lead to material misstatements in the financial statements and the acts represent unethical conduct by management. Their contributions to fraud risk are assessed as high (means = 6.09, 5.66, and 5.08 respectively).

The contribution to fraud risk is quite high (mean = 5.36) for Item 4 (*Individuals related to the directors sell their shares in a subsidiary before the subsidiary was sold*) indicating that auditors perceive that such behaviour is not honest.

Participants assess a moderate contribution to fraud risk (mean = 4.25) for Item 7 (*A director is being investigated by the Australian Tax Office for allegedly reporting significantly less personal income*). The act of reporting less income is perceived as less dishonest than the act of using confidential information for personal gain such as insider trading because the latter is illegal and therefore, it is appropriately thought to contribute to higher risk.

Item 2 (*There have been adjustments showing a reduction in operating expenses and an increase in inventory on a monthly basis but no documentation exists to support these*) is perceived as indicating dishonesty and the contribution to risk is assessed as high (mean = 5.36). This is an obvious case of manipulation of accounting records. The fact that there is no documentation to support the adjustments should trigger probing questions by the auditors. However, the result is not significant. Therefore, it is not conclusive that auditors perceive this as indicating a fraudulent act.

Item 18 (*Invoices payable to a certain supplier have not been processed in the usual manner*) comes from a fictitious fraud case of a city council. It is noted that 46.6% of the participants perceive it as a dishonest act and this is significant at $p < 0.01$. Participants assess its contribution to fraud risk as moderately high (mean = 4.96). Such an act may also indicate a weakness in internal controls.

Other items the auditors perceive as not honest behaviour are Item 16 (*The purchasing manager changed suppliers to the one who appeared to be a good friend of his*), Item 6 (*The directors engage companies that they (and their families) own to do work for the company, for example, interior decoration service*), and Item 35 (*A director gives an expensive gift to a third party in the process of negotiating a contract*). The p-values for these items are significant at the 0.001 level. These items come from fictitious cases and a high percentage of participants (65.94%, 48.15%, and 54.41% respectively) perceive them as indicating dishonesty. Their average assessments of the contribution to the risk of fraud for these items are moderately high (mean = 4.73, 4.65, and 4.58 respectively). Favouritism acts such as these may be considered to have an impact on audit risk, however, the risk is not as high as those behaviours that have a direct impact on the financial reports.

The results clearly show that high contributions to risk are assessed for items that have a direct impact on the financial report. These are Items 28, 11, 5, 39, 4, 2, 23, and 3 and the means for these items are high, i.e., higher than 5.00. Those items with means lower than 5.00 are those that do not have an obvious direct impact on the accounts, i.e., Items 18, 16, 6, 35, 7, 19, and 38. Auditors seem to believe that managers who act dishonestly in their private lives would not necessarily act dishonestly at work, for example, reporting less income tax to the tax authority (Item 7), and the CFO confided that he entered the country as an illegal immigrant (Item 19) are assessed as contributing to medium risk. However, the average assessments of contribution to risk for most of these items are higher than 4.00.

In summary, auditors seem to be able to appropriately identify fraud risk factors for those items that have been discussed in the preceding paragraphs. It is worth noting that some of these are not mentioned in the auditing standards, in particular ASA 240, which is the crucial standard that provides guidelines for auditors to consider fraud risk in their audit of financial statements.

3.3.2 Competent (or Not Competent) Behaviour of Client Management

Table 3.3 contains the 23 items that the auditors perceive as indicating "Competency". Contribution to risk is assessed as high for items that affect the financial reports. Auditors perceive the first 17 items as contributing to high risk, i.e., the means are higher than 4.00. All have significant p-values at the 0.001 level except for Item 26 (*Customers complain about overdue notices. They say they have* *paid and have receipts to prove it. The staff accountant is unable to locate records of the related accounts receivable*), Item 40 (*The accounts manager returns vouchers for payment, without proper authorisation to the purchasing department*) and Item 8 (*The purchasing manager added suppliers to the vendors' list without proper verification*), as their p-values are not significant.

For the items that do not have direct effects on the financial reports, the auditors perceive these as signalling moderate and lower risks (mean < 4.00). These are the last six items in Table 3.3. The p-values are significant at the $p < 0.001$ level, except for Item 45 (*The CFO has a reputation of impeccable integrity and has won a CFO Excellence Award*), which is significant at the $p < 0.01$ level.

The auditors appropriately perceive previous experience (Item 45) or lack of experience (Item 41) as a competency factor. This supports the findings by Monroe et al. (1993), who find that the experience of client personnel is classified as an inherent risk factor at the account balance level. In other words, competency is considered as an important factor in ensuring that financial statements are free from material misstatements due to errors.

Table 3.3
Items Perceived as Competent (or Not Competent) Behaviours and Their Contribution to Risk

Item No.	Item	Frequency, %			χ^2 value	Assessment of Contribution to Risk Mean (SD)
		H	C	N		
26	Customers complain about overdue notices. They say they have paid and have receipts to prove it. The staff accountant is unable to locate records of the related accounts receivable.	28.15	42.22	29.63	4.84	5.69 (0.099)
25	The Financial Controller does not comply with GAAP on some material matters	11.85	60.74	27.41	50.53**	5.65 (0.114)
37	Expired inventory are still included in the valuation of inventory at full cost.	17.78	55.56	26.67	31.60**	5.51 (0.108)
29	The accounts manager processes vouchers for payments without checking for authorisation.	10.22	62.77	27.01	59.23**	5.14 (0.107)
31	The credit manager is unable to explain discrepancies between accounts receivable balances and debtors' confirmations.	16.30	56.30	27.41	34.53**	5.12 (0.099)
36	Accounts payable and accounts receivable are not reconciled.	6.62	66.91	27.21	78.28**	5.09 (0.113)
42	Sales orders received are recognised as sales immediately.	16.91	50.74	32.35	23.40**	5.01 (0.140)
22	The senior accountant has been unable to provide a list of all fixed assets, asset identification numbers, cost, date of purchase, and current location of each item on the list. The excuse given is she has always been busy.	17.04	50.37	32.59	22.53**	5.00 (0.108)
41	The CFO is inexperienced and lacks knowledge of the industry.	3.62	71.74	24.64	100.74**	4.96 (0.127)
12	Management has not rectified weaknesses in internal control that have been reported in the previous audit.	10.95	54.74	34.31	39.47**	4.90 (0.111)
13	The credit manager has not been observing the policy to authorise the adjustments of customers' credit limits.	12.59	57.04	30.37	40.53**	4.89 (0.099)
40	The accounts manager returns vouchers for payment, without proper authorisation to the purchasing department.	32.12	42.34	25.55	5.88	4.85 (0.104)
9	The manager is unable to explain discrepancies arising from the reconciliation of shipping and billing documents.	14.71	61.76	23.53	51.06**	4.80 (0.096)
8	The purchasing manager added suppliers to the vendors' list without proper verification.	35.07	36.57	28.36	1.54	4.77 (0.112)
44	The accounts manager recorded the purchase of a fixed asset as an expense.	11.03	64.71	24.26	63.81**	4.77 (0.123)
1	The accounts manager is unable to answer your questions as to why there has been a dramatic increase in miscellaneous income over the past year.	18.12	58.70	23.19	40.48**	4.58 (0.120)

Table 3.3 (continued)

	Item	Frequency, %				Assessment of Contribution to Risk χ^2 value
		N	C	N		
48	Half of the directors have been absent from board meetings, and, when they are there, they do not contribute significantly in the discussions.	5.07	53.62	41.30	52.74**	4.57 (0.123)
15	Management is very slow in providing the information that you request.	8.09	54.41	37.50	44.84**	3.46 (0.104)
43	The chief accountant reduced the provision for doubtful debts because the company received, just before the year-end, a settlement from a substantial customer, whose account had been overdue for months.	7.97	57.97	34.06	51.78**	2.99 (0.129)
27	The accounts manager is always ready with satisfactory answers when asked about fluctuations in revenue.	7.35	80.88	11.76	138.77**	2.55 (0.104)
45	The CFO has a reputation of impeccable integrity and has won a CFO Excellence Award.	35.61	44.70	19.70	12.68*	1.87 (0.099)
20	The CFO has more than 10 years of experience in the industry.	2.17	81.88	15.94	150.30**	1.87 (0.088)
14	Directors are committed to attend the board of directors meetings and you observe that decision-making in these meetings is always thorough.	8.89	67.41	23.70	74.98**	1.83 (0.091)
	*significant at $p<0.01$ **significant at $p<0.001$					

Item 14 (*Directors are committed to attend the board of directors meetings and you observe that decision-making in these meetings is always thorough*) is assessed as contributing to low error risk (mean = 1.83). This may be an indication that directors' attendance at board meetings is an important aspect of competency. This item is the opposite to what occurred in the HIH Insurance case (Owen 2003), where the directors did not show their commitment by attending board meetings, where on a particular occasion, a very important decision on a material takeover of another company was made. Commitment from directors should ensure that directors know what is going on in the company and are able to prevent material misstatements due to error. Thus, their non-attendance, which is an indication of their non-commitment

in Item 48 (*Half of the directors have been absent from board meetings, and, when they are there, they do not contribute significantly in the discussion*) is appropriately assessed as contributing to moderately high error risk (mean = 4.57).

Both Item 25 (*The Financial Controller does not comply with GAAP on some material matters*) and Item 41 (*The CFO is inexperienced and lacks knowledge of the industry*) contribute to high error risk. Their means are 5.65 and 4.96 respectively and are significant ($p < 0.001$), indicating that both are considered as behaviours of management who are not competent. Insufficient experience and knowledge may not necessarily lead to material misstatement. However, non-compliance with GAAP would almost certainly result in material misstatements and that could be the reason for the assessment of higher contribution to risk for Item 25 compared to Item 41. Normally, auditors would advise management to amend the financial report for such non-compliance. If management disagrees, auditors should be suspicious because management may be trying to conceal certain facts. This is illustrated in a fictitious case, Waste Disposal Incorporated in the US (Ragothaman et al. 2003). Waste Disposal was described as a major player in the domestic and international trash collection industry in the US. Its rapid expansion resulted in substantial profits and its stock price skyrocketed, putting pressure on the company to attain increasing profits. Further, certain actions by management raised questions, for example, offsetting prior period estimates and expense adjustments against the gain from the sale of a subsidiary is not in compliance with GAAP. Additionally, the controller was trying to conceal some expenditure and did not disclose them in the footnotes to the financial statements. Thus, non-compliance with GAAP could be indicative of acts that are not honest acts.

The non-rectification of weaknesses reported in the previous audit in Item 12 is seen as behaviour that is not competent rather than behaviour that is not honest (*Management has not rectified weaknesses in internal control that have been reported in the previous audit*) even though it is one of the fraud cues listed in ASA 240. However, a majority of the auditors in this survey (54.74%) perceived this as behaviour that is not competent rather than behaviour that is not honest and the contribution to error risk is moderately high (mean = 4.90). The audit approach would therefore focus on uncovering errors, but not fraud. This should raise concern in the audit profession. Nonetheless, its opposite, Item 38 in Table 3.2 (*The financial controller expressed concern on a weakness in the control system*) is correctly classified as honest behaviour.

Other items that are listed as fraud cues in ASA 240 are Items 31, 13, 9, and 15. All of these items result in moderately high assessments of contribution to error risk (means = 5.12, 4.89, 4.80 respectively) except for Item 15 where the mean error risk assessment is low (mean = 3.46). Therefore, the audit approach will focus on uncovering errors instead of fraud.

Manager's inability to explain discrepancies in Item 31 (*The credit manager is unable to explain discrepancies between accounts receivable balances and debtors' confirmations*) and Item 9 (*The manager is unable to explain discrepancies arising* *from the reconciliation of shipping and billing documents*) should be treated cautiously by the auditors. A manager usually has some amount of experience before they are appointed as manager and with a little bit of searching through the company's documentation, he should be able to provide an explanation about discrepancies between accounting records and third party's documents or confirmations. Similarly, Item 15 (*Management is very slow in providing the information that you request*) could be an indication that management is trying to conceal fraud before coming up with the requested information.

Items 37, 29, 36, 42, 8, and 1 come from the AICPA's website on cases of ethics and fraud in business (http://fvs.aicpa.org/Resources/Antifraud+Forensic+Accounting/). Item 29 (*The accounts manager processes vouchers for payments without checking for authorisation*) and Item 8 (*The purchasing manager added suppliers to the vendors' list without proper verification*) are cases of gross non-compliance with a company's control procedures rather than inexperienced management. Similarly, Item 37 (*Expired inventory are still included in the valuation of inventory at full cost*) and Item 42 (*Sales orders received are recognised as sales immediately*) are examples of non-compliance with accounting standards. A competent manager would have no difficulty in explaining the dramatic increase in income as in Item 1 (*The accounts manager is unable to answer your question as to why there has been a dramatic increase in miscellaneous income over the past year*) and to ensure that accounting records are correct and thus reconciliations should be an easy and routine task as Item 36 (*Accounts payable and accounts receivable are not reconciled*).

In summary, there are several items that are indicators of honest (or not honest) behaviour that the auditors identify as competent (or not competent) behaviour. In such circumstances, there is a possibility that fraud will not be uncovered as the focus of the audit will be on discovering errors rather than fraud.

3.3.3 Neither Responses

Table 3.4 reports the items that the majority of the participants perceive as neither honest (or not honest) nor competent (or not competent) behaviour (N). The auditors perceive the first eight items as contributing to high error risk, where the mean assessment is higher than 4.00. Most of the results are significant at the $p < 0.001$ level except for Item 33, whose p-value is significant at the $p < 0.05$ level, and Items 24 and 34, whose results are not significant. Nevertheless, these items may be indicative of potential fraud as explained in the following paragraphs.

Table 3.4
Items Perceived as Neither Honesty nor Competency and Their Contribution to Risk

Item No.	Items	Frequency, % H	C	N	χ^2 value	Assessment of Contribution to Risk Mean (SD)
33	The CEO and CFO purposely assign the internal audit department projects that leave the staff little time to perform audit functions.	34.06	23.19	42.75	7.957*	4.85 (0.112)
24	You have not been provided with a complete list of vendors' addresses even after a few requests	28.68	31.62	39.71	2.662	4.65 (0.109)
30	Top management has been in dispute with you, the auditor, over inventory policies.	10.22	35.77	54.01	39.781***	4.55 (0.115)
10	The CEO and CFO have not made available to all managers reports on adjustments made at the corporate level, which are not derived from operating activities.	30.66	19.71	49.64	18.847***	4.41 (0.139)
47	Management does not assist you in accessing electronic files to carry out computerised audit procedures.	18.84	24.64	56.52	34.087***	4.26 (0.124)
34	Some purchase orders have no original copies, just photocopies	25.36	35.51	39.13	4.217	4.25 (0.115)
17	The chief accountant never takes a vacation and when employees are urged to take a reasonable length of vacation each year, he took one day at a time.	41.04	8.21	50.75	39.955***	4.24 (0.163)
46	Four years ago, the senior accountant filed for personal bankruptcy because he had over-extended his credit cards by taking too many cash advances.	28.47	12.41	59.12	46.307***	4.01 (0136)
21	The CEO has pledged his shares in the company as collateral for loan to finance the purchase of his personal outside business interests.	31.88	5.07	63.04	69.696***	3.87 (0.160)
32	The chief accountant is having an affair with an employee.	23.91	1.45	74.64	116.391***	2.64 (0.136)
	*p<0.05 **p<0.01 ***p<0.001					

Item 33 (*The CEO and CFO purposely assign the internal audit department projects that leave the staff little time to perform audit functions*) is an actual occurrence in the Worldcom case (Zekany et al. 2004). The internal audit department was not able to detect fraudulent intention by top management as they were instructed to perform

"special projects" that consumed most of the Internal Audit's staff time, which led to delays in scheduled audits. This could be the reason why fraud had not been discovered much earlier as the Internal Audit's staff were pre-occupied with projects such as generating an Enterprise Resource Planning (ERP) system, which involved compilation of schedules and trend analyses for tracking orders, activations, disconnections, and cancellations received by the company from its customers each month, and estimating revenues associated with those orders. However, the participants in this survey perceive this act as neither not honest nor not competent.

Item 47 (*Management does not assist you [the auditor] in accessing electronic files to carry out computerised audit procedures*) is one of the potential fraud indicators listed in ASA 240. However, participants in this survey do not perceive this as a fraud risk factor. Auditors should be curious as to the reason why management does not assist them in accessing electronic files and this puts a limit on their work. As such, the effectiveness of the audit could be questioned.

Item 17 (*The chief accountant never takes a vacation and when employees are urged to take a reasonable length of vacation each year, he took one day at a time*) and Item 46 (*Four years ago, the senior accountant filed for personal bankruptcy because he had over-extended his credit cards by taking too many cash advances*) are circumstances extracted from a fictitious case of a city council in the US (Strand et al. 2002). In many actual instances, when these people do take leave, discrepancies and often fraud is discovered (Albrecht 2003). Auditors are often cautioned about employees of audit clients who never take leave (Item 17). Being declared a bankrupt previously (Item 46) does not affect the perceptions of the majority of auditors about management's honesty, whereas this could be identified as a pressure (or incentive) for an employee to commit fraud. Albrecht (2003) identifies pressure from personal life as one of the incentives (pressures) for an employee to commit fraud.

Sixty-three percent (63%) of the participants classified Item 21 (*The CEO has pledged his shares in the company as collateral for loan, to finance the purchase of his personal outside business interests*) as neither not honest nor not competent behaviour. Only 31.9% of the auditors perceived this act as a not honest behaviour (mean contribution to risk = 3.87). Perhaps the impact of such an act on the truth and fairness of the financial statements may not be so obvious to the auditors whereas such pressure may lead the CEO to act fraudulently. In such circumstance, the CEO's financial well-being could be dependent on the company's stock price because if the company's stock price falls substantially, the collateral might be insufficient to secure the loans. This was what actually transpired in the WorldCom case and in other companies experiencing going-concern problems. In the WorldCom case, the CEO's shareholding was put up as collateral for his personal outside business interests. This created pressure on him to keep WorldCom stock from declining (Zekany et al. 2004).

Item 30 (*Top management has been in dispute with you, the auditor, over inventory policies*) is an important inherent risk factor (Monroe et al. 1993). However, only 10.22% of the auditors regard this as behaviour that is not honest and 35.77% regard this as behaviour that is not competent. Participants may have viewed this as a technical issue in an audit and did not relate this to the behaviour of client management.

Item 32 (*The chief accountant is having an affair with an employee*) is also not perceived as honest (or not honest) or competent (or not competent) behaviour by the majority of the respondents (74.64%). However, if the employee's job specification relates to the job of the management involved (in this case, the chief accountant), this could affect the chief accountant's objectivity in performing his job, which may lead to unethical acts.

3.4 Sensitivity Test

Tests for equality of variances and means are carried out to determine that the two groups, auditors undergoing training and auditors from the mailed questionnaire groups, are not significantly different. Mann-Whitney two-independent-samples tests are performed on the classifications of behaviours. The null hypothesis is that the two groups are drawn from the same population and, therefore, their probability distributions are equal.

The Mann-Whitney two-independent-samples tests show that the classifications of behaviours for the two groups are not significantly different except for one item, i.e., Item 48 (*Half of the directors have been absent from board meetings, and, when they are there, they do not contribute significantly in the discussion*) for which a two-tailed test results in a p-value of 0.006. Thus, in examining this item, the two groups cannot be assumed as identical. Hence, analysis of the classification of behaviour is separated for this item. The analyses for the classifications of behaviours for the rest of the variables are done together because none of the significance levels exceed p-value of 0.10.

Table 3.5
Test for Equality of Variances and Means for Risk Assessments

Item No.		Levene's Test p-value	2-tailed t-test t-value (p-value)
6.	The directors engage companies that they (and their families) own to do work for the company, for example, interior decoration service.	0.031	.534 (0.595)
11.	A significant amount of physical inventory is missing.	0.005	-.674 (0.504)
13.	The credit manager has not been observing the policy to authorise the adjustments of customers' credit limits.	0.038	-.359 (0.721)
23.	The sales manager sometimes made adjustments to the amounts of credit sales in writing on some of the carbon copies of sales vouchers.	0.039	-1.424 (0.162)
30.	Top management has been in dispute with you, the auditor, over inventory policies.	0.028	-1.207 (0.234)
34.	Some purchase orders have no original copies, just photocopies.	0.012	-2.307 (0.024)*
37.	Expired inventory are still included in the valuation of inventory at full cost.	0.001	-1.197 (0.238)

Levene's test for equality of variances and means shows no significant difference in the variances from the two groups, except for the items shown in Table 3.5. The two-tailed t-test also shows that the means for the two groups are not significantly different except for Item 34 (*Some purchase orders have no original copies, just photocopies*). Separate χ^2-test of the two groups also shows no significant difference with χ^2-values of 2.364 (p-value = 0.307) for the mailed questionnaire group and 1.771 (p-value = 0.412) for the other group.

3.5 Limitations of the Study

While a questionnaire is useful for measuring auditors' perceptions of the behaviour of client management, a limitation is that complete scenarios are not provided, as the case in any questionnaire. Questionnaires must be kept short and, therefore, more detailed information could not be provided for each of the items. Different answers may be generated if the items are described in more complete scenarios. Another limitation is that a "Both H and C" category is not included. Participants are forced to answer either "Honesty" or "Competency" even if they thought a variable could indicate both behaviours.

3.6 Conclusions

The purpose of this study is to identify behaviours that auditors perceive as indicative of the honesty and competency of the audit client's management and how these perceptions contribute to the risk of fraud and error. Dishonesty may be portrayed by company's top and middle level management through their behaviour and attitude in managing the company, which may signal their unethical acts. As such, their behaviour and attitude could be a portrayal of their own interests and greed for example, firing of officers who question their unethical decisions.

The 48 items in the survey are based on ASA 240, actual and fictitious fraud cases the academic literature, and the AICPA's website on Ethics and Business Fraud. The results show that auditors do perceive different behaviours of client management as behaviours indicating honesty or competency. Several potential fraud indicators that have not been appropriately identified by auditors should raise concerns because if fraud indicators are not appropriately identified as fraud risk factors, the selected audit approaches and procedures may not uncover the fraud. The results also show that auditors' perceptions of the honesty and competency of the audit client impact on fraud risk and error risk, whereby negative behaviours produce a high contribution to risk and positive behaviours produce a low contribution to risk.

CHAPTER FOUR

POSITIVITY AND NEGATIVITY BIASES IN AUDITORS' ASSESSMENTS OF AUDIT RISK: THEORY AND HYPOTHESES

4.1 Introduction

Studies in psychology report that people go through the process of impression formation before arriving at a particular perception or judgment of another person's behaviour. The perceiver observes and assesses the various traits or characteristics of the perceived person and adjusts their prior belief about the person. During this process, the perceiver is "anchoring and adjusting" their perceptions, and the perception formed depends on the persuasiveness of the traits or characteristics, which either confirms or disconfirms the initial belief (Anderson and Marchant 1989; Ashton and Ashton 1988).

In perceiving the behaviour of another person, an individual categorises the other individual's characteristics using the available information cues, especially learned or observed behaviours and views some behaviours as more helpful than others in discriminating between alternative trait categorisations (Skowronski and Carlston

1989). Such discrimination is referred to as category diagnosticity, where negative attributes are more influential in the impression formation on honesty and positive attributes are more influential in the impression formation of competency (or ability) (Anderson 1981; Birnbaum 1972; Nisbett et al. 1981; Wyer 1974), i.e., people are subject to positivity and negativity biases in perceiving others' honesty and competency.

Auditors, as professionals, are also subject to these positivity and negativity biases (Anderson and Marchant 1989; Jones 2001). They also display other types of biases in their judgments. Depending on certain factors, auditors display confirmatory and disconfirmatory behaviour in their belief revision process (Ashton and Ashton 1988; Ashton and Ashton 1990; Bamber et al. 1997; Bedard and Biggs 1991; Church 1990).

In addition, negative cues cause auditors to act more cautiously. For example, auditors assess risk as higher, collect more evidence and charge higher fees for low-reputation firms (Ayers and Kaplan 2003; Beaulieu 2001; Johnstone 2000; Kizirian et al. 2005), and auditors are less certain that management information is reliable when management is aggressive (Anderson et al. 2004). In other words, auditors associate management integrity with the risk of material misstatements (Iyer and Reckers 2007). Further, auditors gather more evidence when financial information is negative trending (Coram et al. 2011).

While a few studies in psychology demonstrate such positivity and negativity biases (Klein 1991; Peeters and Czapinski 1990; Singh and Teoh 2000; Skowronski 2002; Skowronski and Carlston 1987; Vonk 1993), only one study examines this issue using auditors as participants. (Anderson and Marchant 1989) find that, in perceiving and evaluating the honesty and competency of client management, auditors display the same biases as other people in that they are negatively biased in perceiving honesty and positively biased in perceiving competency. They find that auditors, in perceiving the honesty and competency of client management, perceive negative behaviours are more diagnostic than positive behaviour in their judgement of honesty and they perceive positive behaviours are more diagnostic than negative behaviour in their judgment of competency. However, their study does not examine how such biases affect auditors' judgments, such as risk assessments. This thesis examines positivity and negativity biases associated with audit client management's behaviour in an experiment as reflected in their audit judgments. Participants make assessments of the truth of an audit assertion based on the descriptions of the honesty and competency of an audit client management and also posterior assessments following the information about a positive or negative change in the client management's behaviour. Further, the present study examines both honesty and competency simultaneously, where a participant is making the assessments based on both the honesty and competency of the client management.

The next section discusses the literature on impression formation. Section 4.3 discusses the positivity and negativity biases that have been found in people's impression formation and that may also have influence on auditors' perceptions and judgments. Section 4.4 provides the summary of the discussions in this chapter.

4.2 Auditors' Impression Formation

People's behaviours provide clues to their motives and traits. Impression formation is a process of behaviour categorisation where people use available cues, such as an individual's behaviours, to assign that individual to one or more trait categories (Asch 1946), for example, whether the person belongs to an honest or not honest category (Rosch 1978). Both the schematic model of attribution (Reeder and Brewer 1979) and the cue-diagnosticity model of impression formation (Skowronski and Carlston 1987) assume that people infer personality traits from others' actions.

However, not all behaviours are equally informative. Behaviours that are more influential in arriving at an impression are considered diagnostic cues. An individual is usually described using multiple cues. As such, the categorisation of an individual's behaviour is determined primarily by those cues that lead to the most confident categorisations, i.e., by the more diagnostic cues. Thus, diagnostic cues serve to make particular trait categorisations more salient and more persuasive to a perceiver, and less diagnostic information is less persuasive.

Skowronski and Carlston (1987) illustrate that people form impressions regarding the honesty and competency of a person based on certain traits portrayed by that person. For example, a person is considered as extremely honest if he returned a lost wallet intact. On the other hand, a person is considered as extremely not honest if he stole $1 million from a bank. Similarly, a person is considered intelligent if he had several essays published in the New Yorker, and a person is considered unintelligent if he does not know how to tie his own shoelaces. Skowronski and Carlston (1987) report the results of a questionnaire consisting of morality- and competency-related behaviour, which they distributed to students in an introductory psychology course. After reading a description of a person's behaviour, the students indicate the level of honesty and competency on a 9-point scale. They find that behaviours that are not honest have more impact than honest behaviours on judgments of honesty/dishonesty and intelligent behaviours have more impact than unintelligent behaviours on judgments of intelligence/stupidity.

Mrug and Hoza (2007) find that subjects in an experiment, consisting of children and adults, form an impression of whether an actor is likeable or not based on prosocial-antisocial behaviour, intellectual ability and behavioural withdrawal, which they observe on a videotape that portrays both an individual's negative and positive behaviours. The subjects in the experiment discriminate between the negative and positive behaviours portrayed by the actors and form impressions accordingly. Gupta (2009) confirms that a celebrity is blameworthy when he is perceived to have played a major role in a negative action and the course of action is under his control. For example, Pepsi terminated its contract with Mike Tyson when he was involved in blameworthy actions.

Research in the auditing literature shows that auditors display the same heuristic process in forming an impression of their client (Anderson and Marchant 1989). The results from Anderson and Marchant (1989) support the results from the survey by Skowronski and Carlston (1987), in which they show that auditors' categorisations of client management's behaviour are similar to those of an ordinary person. In determining the honesty and competency of a client's management, auditors identify those cues (behaviours) that help them to categorise the client's management as honest (or not honest) or competent (or not competent).

Management is a source of audit evidence and, therefore, their honesty and competency affect the credibility of audit evidence obtained from them. Auditors are required to assess the honesty of client management, in particular how management may perpetrate and conceal fraudulent financial reporting (AuASB 2009a) and to assess the competence of client management in assessing inherent risk (AuASB 2009b). Not honest management may engage in fraudulent acts, whereas management who are not competent may unintentionally produce errors. Both are potential causes of material misstatements in the financial report.

The auditing literature reports that the quality of client management, which normally encompasses honesty and competency, affects inherent risk assessments (Colbert 1987, 1988; Langmead and Michenzi 2010; Messier and Austen 2000a).

Assessments of an audit client's management integrity influence the auditor's evaluation of source credibility of management (Beaulieu 2001; Kizirian et al. 2005; Shaub 1996). For example, Kizirian et al. (2005) find that integrity of the audit client is negatively related to auditors' risk assessments.

Hypothesis 1 predicts that auditors will assess the truth of an audit assertion as high when the client management is both honest and competent; and low when the client management is both not honest and not competent. The assessments should be highest when client management is both honest and competent and lowest when client management is both not honest and not competent and their assessments should fall in between these two extremes when client management is not honest but competent; or honest but not competent.

H1a:	***Auditors' assessments of the truth of an assertion are higher when client management is portrayed as honest than when client management is portrayed as not honest.***
H1b:	***Auditors' assessments of the truth of an assertion are higher when client management is portrayed as competent than when client management is portrayed as not competent.***
H1c:	***There is an interaction between client management's honesty and client management's competency on auditors' assessments of the truth of an assertion.***

In the experiment used to test these hypotheses, client management is the client's financial controller. Participants are provided with an initial description of the client's financial controller and then asked to make a set of assessments of the truth of several assertions. After making the initial assessments, the participants are provided with additional information about the client's financial controller and asked to make a second set of assessments on the truth of several assertions. With regard to initial assessments, comparisons are made between auditors' assessments of initial honesty and initial dishonesty; and initial competency and initial incompetency. With regard to auditors' second assessments, comparisons are made between auditors' assessments of honesty and dishonesty; and competency and incompetency after they read the additional information about the financial controller's behaviour.

Research into impression formation indicates that an individual's negative or extreme attributes have an inordinate influence on the perceiver's judgments of their personality characteristics (Anderson 1974; Birnbaum 1972; Fiske 1980; Wyer 1974) as posited by the schematic model of attribution (Reeder and Brewer 1979). Negative behaviours are perceived as more diagnostic than positive behaviours. Positive and negative behaviours are based on cultural definitions of "bad people" and "good people". For example, a person who has been caught cheating would be classified as more likely to lie and steal compared to a person who has not (Reeder and Spores 1983). Further, a single immoral behaviour is often enough to discredit a person and such negative evaluation tends to persist even if that person is simultaneously credited with good behaviour (Birnbaum 1972).

From an audit perspective, prior research shows that auditors modify their risk assessments and audit planning in response to the presence of risk factors, which include behaviour-related factors (Libby 1985; Maletta 1993; Zimbelman 1997).

Auditors are also sensitive to the reliability of evidence source including the level of client's expertise (Rebele et al. 1988); the reliability of internal auditor's attributes (Margheim 1986); and the competency and objectivity of the evidence source (Bamber 1983; Hirst 1994).

Auditors are trained to seek out and use evidence about the "fair presentation" of financial information, and the quality of financial control. There are legal and professional risk consequences of not correctly identifying risk factors as errors and fraud. As such, auditors are trained to be particularly sensitive to evidence that is negative with respect to the "fair presentation" of financial information and internal control due to the professional and legal risk consequences of the audit profession. In the process of seeking and gathering evidence, auditors evaluate whether a piece of new evidence supports or does not support their existing belief about an audit client. This is apparent in studies that examine the relationships between types of evidence and professional judgments.

People's judgments are also influenced by whether information confirms or disconfirms a prior belief. Studies in psychology indicate that individuals have a greater response to confirming evidence than disconfirming evidence[9] (Einhorn and Hogarth 1985; Gorman 1986; Klayman and Ha 1987; Lord et al. 1979) and they are

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[9] Motivated reasoning is the broader literature of confirmation bias. Motivated reasoning is a process whereby a previously held belief or desire affects reasoning in the following steps: (1) hypothesis formation; (2) the search for relevant information (this being the point in motivated reasoning related to confirmation bias); (3) the interpretation or evaluation of the information once found; and (4) the weighting of information in order to arrive at a final judgment (Martin et al. 2006).

generally confirmation prone in their information search strategy (Klayman and Ha 1987).

However, studies in auditing find that auditors display both confirmatory and disconfirmatory behaviour in assessing evidential information. In experiments where auditors are allowed to generate their own hypotheses, they exhibit confirmatory tendencies in the evaluation of evidence (Bedard and Biggs 1991; Church 1990). Auditors are also sensitive to confirming evidence when they are provided with an initial hypothesis to test (Bamber et al. 1997). However, Ashton and Ashton (1988, 1990) find that auditors' belief revisions are greater for disconfirming evidence when they are given an initial likelihood of the error's occurrence. This is consistent with Jones (2001), who finds that auditors seek and use more negative information than positive information given a negative initial impression.

Studies also show that hypothesis framing influences auditors' evaluation of audit evidence. They show a preference for failure cues (as opposed to viable cues) when prior indication indicated failure of company (Trotman and Sng 1989). In addition, depending on the frame of the hypothesis that auditors favour, they react differently to audit evidence. Auditors who favour an error frame (i.e., a hypothesis that a material error exists in the financial statements) react more strongly to confirming and disconfirming evidence than those favouring a non-error frame (McMillan and White 1993).

These findings are consistent with the proposals by Snyder and Swan (1978). They propose that there are three information search strategies, in which individuals:

1. Search for evidence that confirms their hypothesis.
2. Search for evidence that disconfirms their hypothesis.
3. Conduct a "balanced" search where an equal amount of effort is employed to uncover both confirming and disconfirming facts.

In these studies, the negative circumstances (e.g., the failing company) trigger auditors' sensitiveness to audit evidence rather than the positive circumstances (e.g., the viable company). This inclination to information indicating failure of companies is consistent with the professional and legal environment of auditing, which label it as a "conservative" search strategy. Conservative behaviour suggests that auditors would be inclined to employ a search strategy that is biased toward the uncovering of material error (Smith and Kida 1991). However, research on Spanish auditors does not support these findings (Guiral and Esteo 2006). This recent study shows no difference in auditors' behaviour in a negative evaluation framework and those in a viability framework.

Auditors also behave quite differently than business executives in their reactions to evidence (Einhorn and Hogarth 1985; Solomon 2005). While disconfirming evidence causes greater belief revisions than confirming evidence for auditors, confirming and disconfirming evidence have the same effects on decision-making for business executives (Ashton and Ashton 1990). On the other hand, tax professionals exhibit confirmatory behaviour, whereby they prefer information that supports their client's position. As such, they are prone to make recommendations that are preferred by the client (Cloyd and Spilker 1999). This is understandable as they can be seen as advocates of their clients, acting in favour of their clients within the taxation legislation framework whereas auditors are expected to protect the client firm's stakeholders through their professional scepticism and due process of audit (Pinsker et al. 2009).

Drawing from the schematic model of attribution (Reeder and Brewer 1979), it is predicted that the magnitude of auditors' revisions to their assessments will depend on the consistency or inconsistency of the information about the honesty and competency of the client's management. This is stated in the following hypotheses.

H2a:	***Auditors' revisions to their assessments on the truth of an audit assertion are negative or are negative and larger when management is consistently described as not honest (not competent) than their revisions when management is consistently described as honest (competent).***
H2b:	***Auditors' revisions to their assessments on the truth of an audit assertion are negative or are negative and larger when management is initially described as honest (competent) and is subsequently described as not honest (not competent) compared to when they are initially described as not honest (not competent) and are subsequently described as honest (competent).***

H2c:	***Auditors' revisions to their assessments on the truth of an audit assertion are negative or are negative and larger when management is initially described as honest (competent) and subsequent information describes them as not honest (not competent) than when management is initially described as honest (competent) and subsequent information also describes them as honest or (competent).***
H2d:	***Auditors' revisions to their assessments on the truth of an audit assertion are negative or are negative and larger when management is consistently described as not honest (not competent) than their revisions when they are initially described as not honest (not competent) and subsequent information describes them as honest (competent).***

Hypothesis 2a predicts that auditors' revisions to their initial assessments are greater when management is initially described as not honest or not competent and subsequent information also indicates that they are not honest or not competent compared to when they are initially described as honest or competent and subsequent information also indicates that they are honest or competent.

Hypothesis 2b predicts that auditors' revisions to their initial assessments are greater in situations when management is initially described as honest or competent and is subsequently described as not honest or not competent compared to when they are initially described as not honest or not competent and are subsequently described as honest or competent.

Hypothesis 2c predicts that auditors' revisions to their initial assessments are larger when management is initially portrayed as honest or competent and subsequent information describes them as not honest or not competent than when management is initially portrayed as honest or competent and subsequent information also indicates that they are honest or competent.

Hypothesis 2d predicts that auditors' revisions to their initial assessments are larger when management is initially described as not honest or not competent and subsequent information also describes them as not honest or not competent compared to when they are initially described as not honest or not competent and subsequent information describes them as honest or competent.

4.3 Positivity and Negativity Biases in Auditors' Perceptions of Client Management

Asch (1946) introduces two theories to describe the process of impression formation. The first theory is that the total impression of a person is the sum of several independent characteristics plus a general factor.[10] Each characteristic produces its own impression. Forming an impression is an organised process, in which a characteristic is recognised in its particular quality and the next characteristic is similarly recognised and so on until a general impression is conceived. The second theory, which is generally held by psychologists, asserts that in forming an impression of another person, one tries to get at the root of the personality. This

[10] Impression = a+b+c+d+e+G where a to e are characteristics and G is the general impression.

involves perceiving the characteristics in relation to each other. A quality that is central in one impression may become peripheral in another. This explains why negative cues are more diagnostic than positive cues in people's perceptions of honesty/dishonesty and positive cues are more diagnostic than negative cues in their perceptions of competency/incompetency.

Studies examining impression formation find that negative attributes or cues have an inordinate influence on judgments of personality characteristics (Singh and Teoh 2000; Skowronski and Carlston 1987; Vonk 1993; Wyer 1974; Ybarra et al. 2001). This means judgments on impression or impression formation are based on combinations of negative cues that are perceived as diagnostic and positive cues that are not. With morality, positive behaviours may be attributed to factors such as conformity (Jones and Davis 1965) and ingratiation (Jones 1964). People are expected to behave according to "norms", i.e., one has to act honestly to be considered as having high morals. When a person commits an act that deviates from this expectation of high morality, that person will be considered immoral. For example, the public may have the opinion that a political leader who is caught drinking and driving may be forced to step down regardless of the contributions he has made to society. Hence, morality has become the default dimension that people use to understand and think about others.

Asch's proposition is consistent with the integration bias literature (Birnbaum 1972; Fiske 1980; Jones and Davis 1965; Sherif and Sherif 1967; Skowronski and Carlston 1989; Wyer 1973, 1974), which suggests that in judging the honesty or integrity of a person, negative traits or characteristics are central or more deterministic than positive ones and positive traits become peripheral or incidental. On the other hand, positive traits are more deterministic than negative traits in an individual's judgment of another person's competency.

There are three other distinguishable classes of theories commonly cited as explanations for integration biases, namely the expectancy-contrast theories, the frequency-weight theories, and the range theories as shown in Table 4.1. The different views taken by these theories are considered as a measure of bias or extremity.

Table 4.1
Theories Explaining Integration Biases

Integration Biases	Expectancy-Contrast Theories	Adaptation level theory (Helson, 1964) Social judgment theory (Sherif and Sherif, 1967)
	Frequency-Weight Theories	Inference theory (Jones and Davis, 1965) Novelty approach (Fiske, 1980)
	Range Theories	Birnbaum (1972) and Wyer (1973, 1974)
	Category-Diagnosticity Theory	Skowronski and Carlston (1989)

Expectancy-contrast theories assume that integration biases are due to contrast effects in judgment (Helson 1964; Sherif and Sherif 1967). A contrast effect occurs when a stimulus is perceived to be more extreme than it otherwise would be because of comparison of the stimulus with some standard of reference point (or anchor point). This anchor point is assumed to be on the positive end of the scale and is moderate in extremity.[11] For example, people are expected to behave morally but a "perfect" behaviour is "too good to be true". Thus, negative information is judged as more extremely negative than if the anchor is at true neutral (a contrast effect).

Frequency-weight theories view integration biases as a function of the relative influence of different stimulus cues, i.e., informative cues may be more influential determinants of an impression than less informative cues (Fiske 1980; Jones and Davis 1965). One of the major factors affecting the informativeness of a cue is its incongruity from what is expected. Unexpected cues are thus, perceived as more informative and have greater influence on impressions than expected cues (Jones and Davis 1965). Therefore, extreme information gets more weight than moderate information; and negative information gets more weight than positive information when cues are combined into impressions because people expect others to be moderately positive and because moderate information is closer to the normative

[11] Extremity is also explained by these theories. Studies examining extremity under these theories find that extreme information or behaviours have more influence in impression formation compared to positive or moderate information or behaviours. This is because people are expected to behave more moderately or in a positive manner. Thus, when extreme behaviour is observed, more weight is given to it (Kaplan 1973).

expectancy. Similarly, novelty theory argues that rare, novel or distinctive information is more informative because it enhances a perceiver's ability to distinguish among people (Fiske 1980).

Range theories (Birnbaum 1972; Wyer 1974) use the overlap in cue distribution to narrow the range of trait ratings that are predicted for a stimulus actor. These theories view impressions as contingent on the ambiguities and discrepancies of the different cues contributing to the impression judgment. Range theories assume that every stimulus cue implies some range of possible values along a dimension of judgment. The size of this range (or distribution of implications) reflects cue ambiguity or uncertainty; the narrower a cue's distribution, the less ambiguous is its implications.

These theories explain the negativity bias very well, however, they fail to sufficiently explain the positivity bias. Category-diagnosticity theory (Skowronski and Carlston 1987) has the advantage of being able to explain both the positivity and negativity biases in a person's perceptions of another person's behaviour. Category-diagnosticity theory applies the principles of natural object categorisation models to person perception to better explain the process and mechanisms involved in the integration biases.[12] When an individual is defined by several cues, categorisation is

[12] Cantor and Mischel (1979) define the classification of objects into categories as the grouping of objects and other people according to similarities in their essential features. Cantor and Mischel (1979) and Lingle et al. (1984) apply the natural object categorisation models successfully in person perception studies. It is an approach to integration biases that views impression formation as a categorisation process. When a target is defined by multiple cues, categorisation should be determined by the more diagnostic cues.

determined by those cues that are more diagnostic. For example, stealing money is likely to be perceived as more informative with regard to a person's dishonesty or honesty than his eating habits. Individuals possessing both positive and negative traits may perform actions that are inconsistent with their character. When the traits involved are related to morality dimensions, people generally expect more inconsistency from those perceived as possessing negative traits than from those perceived as possessing positive traits. Thus, when confronted with two equal but opposite cues when assessing morality, an individual generally assigns the negative cues more weight thus, producing a negativity bias (Anderson and Marchant 1989; Klein 1991; Skerratt and Woodhead 1992; Skowronski 2002; Vonk and Van Knippenberg 1994; Wojciszke et al. 1998; Ybarra 2001, 2002).

On the other hand, when the observed traits are related to competency, the ability of an individual is defined more positively. People reason out an individual's non-performance and attribute it to some other reason than the attributes of the observed individuals. With ability categories, non-performance is attributed to factors such as fatigue and lack of motivation (Anderson and Butzin 1974; Kun 1977; Surber 1984), while success is indicative of ability (Heider 1958). Therefore, when faced with two equal but opposite cues in assessing competency, an individual generally assigns the positive cues more weight, thus producing a positivity bias. For example, a tennis champion who has been winning all games but loses one game will still be regarded as a champion. Losing a game is not considered as an indication of the athlete's whole life's performance and ability. He may not be able to perform at his best due to fatigue or his surroundings. Later studies find that perceptions of a person's competency are affected by a positivity bias (Anderson and Marchant 1989; Betz et al. 1992; Gannon et al. 1994; Hess et al. 1999; Singh and Teoh 2000; Skowronski 2002; Skowronski and Carlston 1987).

The cue-diagnosticity theory of impression formation (Skowronski and Carlston 1987) hypothesises differences in the processing of morality and competency information. This theory proposes that morality judgements are more saturated with affect than competency judgements. Morality judgments are therefore more dominant in global impression formation and information on competence plays a modifier role. It comes to play only after the basic approach-avoidance decision (i.e., moral judgement) has been made. It is then expected that morality categories play an important role at different stages of impression formation. Therefore, the integration of incongruent information results in a negativity bias in the morality domain, and a positivity bias in the competency domain (Skowronski 2002; Skowronski and Carlston 1987; Wojciszke 2005a, b; Wojciszke et al. 1998). Thus, in revising a prior belief of honesty, individuals are negatively biased; and in revising a prior belief of competency, individual are positively biased (Anderson and Marchant 1989; Birnbaum 1972; Skowronski and Carlston 1987, 1992; Wyer 1974).

Studies find that auditors are subject to biases in their judgments and decision-making, for example, confirming and disconfirming evidence affect their information search techniques (Jones 2001; Klayman and Ha 1987; Snyder and Swann 1978), and evaluation of evidence (Bedard and Biggs 1991; Church 1990) as discussed in the previous section. Auditors' judgments are also affected by the order of the evidence

(Ahlawat 1999; Asare 1992; Ashton and Ashton 1988; Brown 2009; Cuccia and Mc Gill 2000); the types of the evidence (Ashton and Ashton 1988; Ashton and Ashton 1990; Butt and Campbell 1989; Hogarth and Einhorn 1992; Pei et al. 1992); and the integrity of the evidence source (Anderson et al. 2004; Beaulieu 2001; Cohen and Hanno 2000; Iyer and Reckers 2007; Kizirian et al. 2005).

The integrity of the source of evidence is very much related to the characteristics of the audit client's management. Information gathered from honest and competent management is more reliable than the information obtained from management who are not competent and not honest. ASA 240 requires auditors to discuss any unusual or unexplained changes in the behaviour of management or staff. SAS 99 recommends that auditors attend to management's behavioural characteristics in interviews as such behaviours may suggest the use of deception to conceal fraud. This requires auditors to observe and perceive the competency and integrity of management.

The findings from Anderson and Marchant (1989) are consistent with the findings in Skowronski and Carlston (1987). Auditors do not act differently than ordinary people in perceiving their clients' behaviours. They are affected by a negativity bias in perceiving the honesty of the client management and by a positivity bias in perceiving the competency of client management (Anderson and Marchant 1989). Based on the preceding explanations, it is hypothesised that auditors are negatively biased in perceiving honesty and positively biased in perceiving competency of audit client management. These biases should affect their risk assessments when making judgements based on evidence provided by client management. Their audit judgments should also reflect a negativity bias for information related to the honesty of client management and a positivity bias for information related to the competency of client management. Therefore, auditors' revisions to their initial assessments of whether an audit assertion is true will be larger when there is a positive change to competency (i.e., the financial controller is initially described as not competent and subsequently described as competent) than when there is a positive change to honesty (i.e., the financial controller is initially described as not honest and subsequently described as honest); and also when there is a negative change to honesty (i.e., the financial controller is initially described as honest and subsequently described as not honest) than when there is a negative change to competency (i.e., the financial controller is initially described as competent and subsequently described as not competent). These are stated in the following hypotheses:

H3a:	***Auditors' revisions to their assessments of the truth of an audit assertion are positive or positive and larger when there is a positive change in the descriptions about client management's competency than their revisions when there is a positive change in the descriptions about client management's honesty.***
H3b:	***Auditors' revisions to their assessments of the truth of an audit assertion are negative or negative and larger when there is a negative change in the description about client management's honesty than their revisions when there is a negative change in the description about client management's competency.***

4.4 Summary

Biases occur in people's perceptions of others. Research in the integration bias literature finds that perceptions of honesty are affected by a negativity bias and perceptions of competency are affected by a positivity bias (Betz et al. 1992; Gannon et al. 1994; Hess et al. 1999; Singh and Teoh 2000). The category-diagnosticity approach to integration biases predicts that not honest (negative morality) behaviour is perceived as more diagnostic than honest (positive morality) behaviour and that ability categories are defined more in terms of positive than negative performances, and thus positive performance is perceived as more diagnostic.

Generally, greater belief revision occurs when an individual is presented with negative information compared to when they are presented with positive information. In such a situation, auditors may display confirmatory behaviour where they search for more information to confirm their initial belief with regard to issues such as going-concern problem, client management's lack of integrity, and client management's aggressive approach. In relation to auditors' judgments of client management's behaviour, the variables examined by Anderson and Marchant (1989) represent general life situations rather than real audit situations. This raises question as to whether auditors' judgments based on information provided by client management whose behaviour has signalled their honesty and competency are influenced by these biases.

This thesis examines how positivity and negativity biases affect auditors' judgments on the assessments of audit assertions.

CHAPTER FIVE

CASE STUDY DEVELOPMENT

5.1 Introduction

This chapter outlines the development of the case materials to be used in the behavioural experiment. Section 5.2 discusses the development of case study for the behavioural experiment. It explains the case materials and the operationalisations of the audit client management's honesty and competency, which are based on the results from the survey (see Chapter Three). Section 5.3 describes the dependent variable, which are the audit assertions to be assessed by the participants.

5.2 Case Study Development

A partial factorial design from a 2 x 2 x 2 x 2 (initial honesty x initial competency x second honesty x second competency) research design is used to test the hypothesis. The variables manipulated are two descriptions (initial description and a second description) about the honesty and competency of client management, which are manipulated at two levels; positive (honest and competent) and negative (not honest and not competent).

Based on an experimental case study, the participants make a series of risk assessments with respect to three assertions and two overall assertions relating to cash transactions and account balances. The three assertions the participants assess are completeness, cut-off and accuracy of cash transactions. The overall assertions concern the truth and fairness of the audit client's cash transactions and the cash and cash equivalent balances on the balance sheet. These assertions are used as they relate to the information provided in the experiment.

As a result of this design there are 16 possible cases. However, only 12 cases are used, resulting in a partial factorial design. This is due to the reason that I had access to only 200 auditors and, therefore, I restricted the design to 12 cells so that I could have an average of 16 - 17 observations for each cell. Accordingly, I decided to exclude the cases where the subsequent information indicated the same honesty and competency traits as the initial information provided to the participants, i.e., where honest and competent management is still honest and competent; not honest and not competent management is still not honest and not competent; honest but not competent is still honest but not competent; and not honest but competent is still not honest but competent. The objective of the experiments is to show the best (superior) treatments. Thus, I am more interested in using the cases that would produce the largest differences in risk assessments when there are changes in the descriptions of management's behaviour. For these cases, I expected there would be no change in risk assessments or the smallest change in risk assessments compared to the other cases (if there were to be any changes) for these cases where the second set of information indicates that management maintains their initial behaviour for both honesty and competency. The manipulations of honesty and competency included in the study are shown in Table 5.1 below.

Table 5.1
Combinations of the Manipulations of Variables

From	To
Honest and Competent	Honest and not competent Not honest and competent Not honest and not competent
Honest and not competent	Honest and competent Not honest and competent Not honest and not competent
Not honest and competent	Honest and competent Honest and not competent Not honest and not competent
Not honest and not competent	Honest and competent Honest and not competent Not honest and competent

5.2.1 Tasks in the Case Study

The case study used in the experiment is based on a real company listed on the ASX. The reason the case material is based on an actual company is to ensure that the relativity between figures presented over the two years is reasonable and realistic. However, the information on audit procedures and findings and behaviours of manager are made up for the purpose of manipulating the independent variables. The case was pilot tested by seven (7) attendees at the Australia National Centre of Audit and Assurance Research (ANCAAR) Conference. Based on their responses and suggestions to the case material, improvements were made to the case study.

The flow of tasks to be performed by participants is presented in Exhibit 5.1 while the full case instrument is presented in Appendix 3. The case study consists of three parts and can be completed in approximately 20 - 25 minutes. Part 1 of the case study consists of the background information of the company, which includes financial information, general descriptions on internal controls and statement of corporate governance, and descriptions of financial controller that relate to the honesty and competency of the financial controller.

Exhibit 5.1
Task Description

PART 1

Background Information Including Initial Descriptions of the Honesty and Competency of the Financial Controller

PART 2

MAIN TASK

Audit Evidence on Five Audit Assertions Relating to Cash Transactions

Assessments of Five Cash-related Audit Assertions

Subsequent Information in Relation to the Honesty or Competency of the Financial Controller

Assessments of the Same Five Audit Assertions

PART 3

Debriefing Questions:-

Set 1: Manipulation checks

Set 2: Demographic information

Participants are told to assume the role of the auditor of the client company in the case material. The client company in the case material, Telcom Limited (not the actual name) is the largest specialist mobile communications retailer in Australia. It started as a single mobile communication store about a decade ago and has grown into a company that has 150 stores around the country and it has plans to open more stores. It was first listed on the Australian Stock Exchange (ASX) in November 2005. Telcom is described as enjoying good growth in profits for the past years and the chairman is confident that the company can maintain this. Other information such as the share price, which shows a significant increase since its initial public offering; and brief information on a few post-balance sheet events are also given. The mobile telecommunication industry is described as competitive and the environment is described as always changing with various ranges of products offered by major service providers in Australia. The statement on corporate governance, remuneration of directors, and audit engagement are also included in the case study. A summary of financial information, comprising income statements, balance sheets, and cash flow statements for the past two years are presented as part of the case material. This information is not manipulated in the experiment and, therefore, remains the same for all the cases.

With regard to the audit engagement, participants are informed that Telcom is an existing audit client and the audit firm has been auditing Telcom since it became a publicly listed company. The reason for choosing a task where there is an existing client is to indicate to participants that the auditors already have some experience with the company and are able to assess the impact of any changes to management behaviour on their work.

Part 1 also includes information on the materiality levels for balance sheet items and income statement items. Participants are also informed that internal control is assessed as moderate. All participants receive the same background information except for the information that relates to the financial controller's honesty and competency.

The initial description of the behaviour of the financial controller is also presented in Part 1. This is one of the manipulated variables. Participants receive different descriptions of the honesty and competency of the financial controller. For example, a financial controller who is initially described as honest and competent has the description shown in Panel A of Exhibit 5.2. The first paragraph relates to honesty of the financial controller while the second paragraph relates to his competency. Panel B of Exhibit 5.2 shows the description of the financial controller who is initially described as not honest and not competent. The name of the financial controller in the case materials is Mr Stewart.

Exhibit 5.2
An Example of Initial Manipulation of Honesty and Competency

Panel A: Initial behaviour is honest and competent
Mr Stewart always expresses his concerns whenever he feels that some aspects of internal control are not observed. Telcom's internal control is assessed as moderate. However, in most cases where breakdowns have been observed in Telcom's internal control procedures in past audits, and with Mr Stewart's help, you were able to perform related substantive audit procedures to identify any material misstatements that might exist in the accounts.

Mr Stewart is a Chartered Accountant. He joined Telcom in June 2004 as a Financial Controller. Before taking up the position at Telcom, Mr Stewart had been working with Telstra in a similar position for ten years.

Panel B: Initial behaviour is not honest and not competent
During the previous year's audit, you audited a sample of non-inventory transactions in the cash payments journal. You discovered that one of the travel expenditures paid by Telcom was for airfares to Hawaii for Mr Stewart and his family. The expenditure had been approved only by Mr Stewart. You had pointed this out to Mr. Stewart. Nevertheless, there was no adjustment made with respect to this personal payment.

Your current year's audit also revealed that there were a number of sales invoices included in the current year's results for product sales that were actually delivered on the first two days of the next financial year despite the fact that title to the goods did not transfer until the goods were delivered to the customer. The items had not been included in inventory, but the profit on these sales had effectively been "anticipated". The effect was a material increase in profit. Mr Stewart refused to reverse the sales as he argued there was no question about whether the profits were real or not, it was just a matter of one or two day's timing. Subsequent discussions with Mr Stewart indicated to you that he was not aware that title to the goods did not transfer until the goods were delivered to the customer.

Part 2 of the instrument instructs participants to provide their assessments of the audit assertions on a seven-point scale that indicates how strongly they believe that the assertion is true or not true based on audit evidence provided regarding particular audit assertions and the background information. The audit findings pertaining to the three assertions are consistent in all the cases. The scales are anchored by "1" - "Strongly believe that the assertion is NOT true" and "7" - "Strongly believe that the assertion is true". Exhibit 5.3 sets out this instruction. Participants are specifically required not to change their answers to the audit assertions once they moved on to the next section of the case study.

Exhibit 5.3
Instruction for Part 2 of the Instrument

For this part, please provide your assessments on the audit assertions. Your judgment will be in the form of circling a number on a seven-point rating scale that indicates how strongly you believe that the assertion is true or not true. The scales are anchored by "Strongly believe that the assertion is NOT true" and "Strongly believe that the assertion is true". The following pages describe some of the audit procedures and the audit evidence you have obtained relating to the determination of the three assertions. In stating your assessment on one audit assertion, you should take into consideration only (1) audit evidence regarding that particular audit assertion and (2) the background information.

The next section of Part 2 provides the participants with additional information that also relates to the honesty and competency of the financial controller. This is also a manipulated independent variable. The information is either consistent or inconsistent with the initial description of the financial controller's honesty and competency. After reading this additional information, the participants make a revised assessment of the same audit assertions. The posterior assessments represent the auditors' judgments that reflect their perceptions including the additional information about the behaviour of the financial controller. Exhibit 5.4 illustrates an example of the description of honest but not competent controller. The first paragraph relates to the honesty of the financial controller and the second paragraph relates to his competency.

Exhibit 5.4
An Example of Subsequent Manipulation of Honesty and Competency

During the current year's audit, Mr Stewart has been frank and forthright in his communications with you about the company's internal control systems. For example, he has brought to your attention a weakness in the control systems with respect to the lack of proper authorisation of payments to some vendors. You had a few discussions with him regarding this and then performed additional audit procedures.

Your current year's audit also revealed that there were a number of sales invoices included in the current year's results for product sales that were actually delivered on the first two days of the next financial year despite the fact that title to the goods did not transfer until the goods were delivered to the customer. The items had not been included in inventory, but the profit on these sales had effectively been "anticipated". The effect was a material increase in profit. Mr Stewart refused to reverse the sales as he argued there was no question about whether the profits were real or not, it was just a matter of one or two day's timing. Subsequent discussions with Mr Stewart indicated to you that he was not aware that title to the goods did not transfer until the goods were delivered to the customer.

There are 12 different versions of the instrument. The full variations of these versions are presented in Exhibit 5.5. The first column in Exhibit 5.5 contains the initial honesty and competency; in which the first paragraph describes the honest/not honest behaviour of the financial controller and the second paragraph describes the competent/not competent behaviour of the financial controller. There are four variations of the initial behaviours; the financial controller is described as honest and competent in Condition 1, he is described as honest and not competent in Condition 2, he is described as not honest and competent in Condition 3 and as not honest and not competent in Condition 4.

The second column contains the additional information on the behaviour of the financial controller. There are three types of additional information for each initial behaviour. For example, in Condition 1, the financial controller is initially described as honest and competent and the additional information describes his behaviour as either: (1) honest and not competent; (2) not honest and competent; or (3) not honest and not competent.

Exhibit 5.5
Variations of Case Instrument

<table>
<tr><th colspan="2">CONDITION 1</th></tr>
<tr><th>Initial Behaviour</th><th>Subsequent Behaviour</th></tr>
<tr><td rowspan="3"><u>Honest and Competent</u>
Mr Stewart always expresses his concerns whenever he feels that some aspects of internal control are not observed. Telcom's internal control is assessed as moderate. However, in most cases where breakdowns have been observed in Telcom's internal control procedures in past audits, and with Mr Stewart's help, you were able to perform related substantive audit procedures to identify any material misstatements that might exist in the accounts.

Mr Stewart is a Chartered Accountant. He joined Telcom in June 2004 as a Financial Controller. Before taking up the position at Telcom, Mr Stewart had been working with Telstra in a similar position for ten years.</td><td><u>Honest and Not Competent</u>
During the current year's audit, Mr Stewart has been frank and forthright in his communications with you about the company's internal control systems. For example, he has brought to your attention a weakness in the control systems especially with respect to the lack of proper authorisation of payments to some vendors. You had a few discussions with him regarding this and then performed additional audit procedures.

Your current year's audit also revealed that there were a number of sales invoices included in the current year's results for product sales that were actually delivered on the first two days of the next financial year despite the fact that title to the goods did not transfer until the goods were delivered to the customer. The items had not been included in inventory, but the profit on these sales had effectively been "anticipated". The effect was a material increase in profit. Mr Stewart refused to reverse the sales as he argued there was no question about whether the profits were real or not, it was just a matter of one or two day's timing. Subsequent discussions with Mr Stewart indicated to you that he was not aware that title to the goods did not transfer until the goods were delivered to the customer.</td></tr>
<tr><td><u>Not Honest and Competent</u>
You audited a sample of non-inventory transactions in the cash payments journal. You discovered that one of the travel expenditures paid by Telcom was for airfares to Hawaii for Mr Stewart and his family. The expenditure had been approved only by Mr Stewart. You had pointed this out to Mr. Stewart. Nevertheless, there was no adjustment made with respect to this personal payment.

Mr Stewart was recently honoured with the prestigious CFO of the Year Award. This award is presented annually to an outstanding CFO who has demonstrated, to an independent panel, outstanding levels of achievements across six professional attributes including a high technical competence in corporate accounting and financial reporting.</td></tr>
<tr><td><u>Not Honest and Not Competent</u>
You audited a sample of non-inventory transactions in the cash payments journal. You discovered that one of the travel expenditures paid by Telcom was for airfares to Hawaii for Mr Stewart and his family. The expenditure had been approved only by Mr Stewart. You had pointed this out to Mr. Stewart. Nevertheless, there was no adjustment made with respect to this personal payment.

Your current year's audit also revealed that there were a number of sales invoices included in the current year's results for product sales that were actually delivered on the first two days of the next financial year despite the fact that title to the goods did not transfer until the goods were delivered to the customer. The items had not been included in inventory, but the profit on these sales had effectively been "anticipated". The effect was a material increase in profit. Mr Stewart refused to reverse the sales as he argued there was no question about whether the profits were real or not, it was just a matter of one or two day's timing. Subsequent discussions with Mr Stewart indicated to you that he was not aware that title to the goods did not transfer until the goods were delivered to the customer.</td></tr>
</table>

Exhibit 5.5 (continued)

<table>
<tr><th colspan="2">CONDITION 2</th></tr>
<tr><th>Initial Behaviour</th><th>Subsequent Behaviour</th></tr>
<tr><td rowspan="3"><u>Honest and Not Competent</u>
Mr Stewart always expresses his concerns whenever he feels that some aspects of internal control are not observed. Telcom's internal control is assessed as moderate. However, in most cases where breakdowns have been observed in Telcom's internal control procedures in past audits, and with Mr Stewart's help, you were able to perform related substantive audit procedures to identify any material misstatements that might exist in the accounts.

Your current year's audit also revealed that there were a number of sales invoices included in the current year's results for product sales that were actually delivered on the first two days of the next financial year despite the fact that title to the goods did not transfer until the goods were delivered to the customer. The items had not been included in inventory, but the profit on these sales had effectively been "anticipated". The effect was a material increase in profit. Mr Stewart refused to reverse the sales as he argued there was no question about whether the profits were real or not, it was just a matter of one or two day's timing. Subsequent discussions with Mr Stewart indicated to you that he was not aware that title to the goods did not transfer until the goods were delivered to the customer.</td>
<td><u>Honest and Competent</u>
During the current year's audit, Mr Stewart has been frank and forthright in his communications with you about the company's internal control systems. For example, he has brought to your attention a weakness in the control systems especially with respect to the lack of proper authorisation of payments to some vendors. You had a few discussions with him regarding this and then performed additional audit procedures.

Mr Stewart was recently honoured with the prestigious CFO of the Year Award. This award is presented annually to an outstanding CFO who has demonstrated, to an independent panel, outstanding levels of achievements across six professional attributes including a high technical competence in corporate accounting and financial reporting.</td></tr>
<tr><td><u>Not Honest and Competent</u>
You audited a sample of non-inventory transactions in the cash payments journal. You discovered that one of the travel expenditures paid by Telcom was for airfares to Hawaii for Mr Stewart and his family. The expenditure had been approved only by Mr Stewart. You had pointed this out to Mr. Stewart. Nevertheless, there was no adjustment made with respect to this personal payment.

Mr Stewart was recently honoured with the prestigious CFO of the Year Award. This award is presented annually to an outstanding CFO who has demonstrated, to an independent panel, outstanding levels of achievements across six professional attributes including a high technical competence in corporate accounting and financial reporting.</td></tr>
<tr><td><u>Not Honest and Not Competent</u>
You audited a sample of non-inventory transactions in the cash payments journal. You discovered that one of the travel expenditures paid by Telcom was for airfares to Hawaii for Mr Stewart and his family. The expenditure had been approved only by Mr Stewart. You had pointed this out to Mr. Stewart. Nevertheless, there was no adjustment made with respect to this personal payment.

During the year, Telcom Ltd. hired a computer expert to do in-house software development that can help to improve communication between all its stores in Australia in order to manage their operations better. Part of the costs involved was for the evaluation and final selection of possible alternatives for improved processes and systems, which are considered as research costs. Mr Stewart instructed that these costs be capitalised even though this is not in accordance with AASB138 "Intangible Assets". Subsequent discussions with Mr Stewart indicated that he did not really understand the provisions in AASB138 "Intangible Assets".</td></tr>
</table>

Exhibit 5.5 (continued)

CONDITION 3	
Initial Behaviour	**Subsequent Behaviour**
<u>**Not Honest and Competent**</u> During the previous year's audit, you audited a sample of non-inventory transactions in the cash payments journal. You discovered that one of the travel expenditures paid by Telcom was for airfares to Hawaii for Mr Stewart and his family. The expenditure had been approved only by Mr Stewart. You had pointed this out to Mr. Stewart. Nevertheless, there was no adjustment made with respect to this personal payment. Mr Stewart is a Chartered Accountant. He joined Telcom in June 2004 as a Financial Controller. Before taking up the position at Telcom, Mr Stewart had been working with Telstra in a similar position for ten years.	<u>**Honest and Competent**</u> During the current year's audit, Mr. Stewart has been frank and forthright in his communications with you about the company's internal control systems. For example, he has brought to your attention a weakness in the control systems especially with respect to the lack of proper authorisation of payments to some vendors. You had a few discussions with him regarding this and then performed additional audit procedures. Mr Stewart was recently honoured with the prestigious CFO of the Year Award. This award is presented annually to an outstanding CFO who has demonstrated, to an independent panel, outstanding levels of achievements across six professional attributes including a high technical competence in corporate accounting and financial reporting.
	<u>**Honest and Not Competent**</u> During the current year's audit, Mr. Stewart has been frank and forthright in his communications with you about the company's internal control systems. For example, he has brought to your attention a weakness in the control systems especially with respect to the lack of proper authorisation of payments to some vendors. You had a few discussions with him regarding this and then performed additional audit procedures. Your current year's audit also revealed that there were a number of sales invoices included in the current year's results for product sales that were actually delivered on the first two days of the next financial year despite the fact that title to the goods did not transfer until the goods were delivered to the customer. The items had not been included in inventory, but the profit on these sales had effectively been "anticipated". The effect was a material increase in profit. Mr Stewart refused to reverse the sales as he argued there was no question about whether the profits were real or not, it was just a matter of one or two day's timing. Subsequent discussions with Mr Stewart indicated to you that he was not aware that title to the goods did not transfer until the goods were delivered to the customer.
	<u>**Not Honest and Not Competent**</u> During the current year's audit, you discovered that there have been reductions made to the operating expenses and increases in the inventory account on a monthly basis. When asked about this, Mr Stewart explained that these are normal adjustments. However, there was no documentation to support this. When asked about the lack of documentation, Mr Stewart became evasive and ended the conversation with a promise to "look into it". He has never come back to you on this issue. Your current year's audit also revealed that there were a number of sales invoices included in the current year's results for product sales that were actually delivered on the first two days of the next financial year despite the fact that title to the goods did not transfer until the goods were delivered to the customer. The items had not been included in inventory, but the profit on these sales had effectively been "anticipated". The effect was a material increase in profit. Mr Stewart refused to reverse the sales as he argued there was no question about whether the profits were real or not, it was just a matter of one or two day's timing. Subsequent discussions with Mr Stewart indicated to you that he was not aware that title to the goods did not transfer until the goods were delivered to the customer.

Exhibit 5.5 (continued)

<table>
<tr><th colspan="2">CONDITION 4</th></tr>
<tr><th>Initial Behaviour</th><th>Subsequent Behaviour</th></tr>
<tr><td rowspan="3"><u>Not Honest and Not Competent</u>
During the previous year's audit, you audited a sample of non-inventory transactions in the cash payments journal. You discovered that one of the travel expenditures paid by Telcom was for airfares to Hawaii for Mr Stewart and his family. The expenditure had been approved only by Mr Stewart. You had pointed this out to Mr. Stewart. Nevertheless, there was no adjustment made with respect to this personal payment.

Your current year's audit also revealed that there were a number of sales invoices included in the current year's results for product sales that were actually delivered on the first two days of the next financial year despite the fact that title to the goods did not transfer until the goods were delivered to the customer. The items had not been included in inventory, but the profit on these sales had effectively been "anticipated". The effect was a material increase in profit. Mr Stewart refused to reverse the sales as he argued there was no question about whether the profits were real or not, it was just a matter of one or two day's timing. Subsequent discussions with Mr Stewart indicated to you that he was not aware that title to the goods did not transfer until the goods were delivered to the customer.</td>
<td><u>Honest and Competent</u>
During the current year's audit, Mr. Stewart has been frank and forthright in his communications with you about the company's internal control systems. For example, he has brought to your attention a weakness in the control systems especially with respect to the lack of proper authorisation of payments to some vendors. You had a few discussions with him regarding this and then performed additional audit procedures.

Mr Stewart was recently honoured with the prestigious CFO of the Year Award. This award is presented annually to an outstanding CFO who has demonstrated, to an independent panel, outstanding levels of achievements across six professional attributes including a high technical competence in corporate accounting and financial reporting.</td></tr>
<tr><td><u>Honest and Not Competent</u>
During the current year's audit, Mr. Stewart has been frank and forthright in his communications with you about the company's internal control systems. For example, he has brought to your attention a weakness in the control systems especially with respect to the lack of proper authorisation of payments to some vendors. You had a few discussions with him regarding this and then performed additional audit procedures.

During the year, Telcom Ltd. hired a computer expert to do in-house software development that can help to improve communication between all its stores in Australia in order to manage their operations better. Part of the costs involved was for the evaluation and the final selection of possible alternatives for improved processes and systems; which are considered as research costs. Mr Stewart instructed that these costs be capitalised. This is not in accordance with AASB138 "Intangible Assets (In Particular Software)". Subsequent discussions with Mr Stewart indicated that he did not really understand the provisions in AASB138 "Intangible Assets".</td></tr>
<tr><td><u>Not Honest and Competent</u>
During the current year's audit, you discovered that there have been reductions made to the operating expenses and increases in the inventory account on a monthly basis. When asked about this, Mr Stewart explained that these are normal adjustments. However, there was no documentation to support this. When asked about the lack of documentation, Mr Stewart became evasive and ended the conversation with a promise to "look into it". He has never come back to you on this issue.

Mr Stewart was recently honoured with the prestigious CFO of the Year Award. This award is presented annually to an outstanding CFO who has demonstrated, to an independent panel, outstanding levels of achievements across six professional attributes including a high technical competence in corporate accounting and financial reporting.</td></tr>
</table>

Part 3 of the instrument consists of debriefing questions. The questions in Set 1 as shown in Exhibit 5.5 capture the auditors' perceptions of the honesty and competency level of the financial controller. Participants assess the honesty of the financial controller on a seven-point scale anchored by "1" – "Dishonest" and "7" – "Honest". Participants assess the competency of the financial controller on a seven-point scale anchored by "1" – "Incompetent" and "7" – "Competent". Set 2 consists of demographic questions of the participants.

Exhibit 5.6
Question Set 1

1.	Please assess the level of honesty of the Financial Controller.						
	1	2	3	4	5	6	7
	Dishonest			Moderately Honest			Honest
2.	Please assess the level of competency of the Financial Controller.						
	1	2	3	4	5	6	7
	Incompetent			Moderately Competent			Competent

5.2.2 Manipulations of Honesty and Competency of Audit Client's Management

Studies on the perceptions of people's behaviour find that honesty and competency are perceived quite differently (Anderson 1981; Eiser and Stroebe 1972; Fiske 1980; Klein 1991; Mezulis et al. 2004; Peeters and Czapinski 1990; Sears 1983; Skowronski and Carlston 1989; Vonk 1993; Vonk and Van Knippenberg 1994; Ybarra 2001). Auditors also perceive the honesty and competency of audit client quite differently and in a manner consistent with the findings in psychology (Anderson and Marchant 1989). Category-diagnosticity theory predicts that perceptions of honesty are negatively biased while perceptions of competency are positively biased. This is discussed in Chapter Four. Generally, the findings from the literature support the category-diagnosticity theory. Therefore, the manipulations in the case studies are to examine the existence of these biases in auditors' perceptions.

The case material in the experiment uses cues to indicate honest or not honest and competent or not competent behaviour, which are selected based on the results from the survey discussed in Chapter Three. The results from the survey form the basis to the operationalisation of the variables in the case study. The descriptions of the client behaviour chosen to operationalise honest and competent are selected from the items in the survey that scored the lowest assessed mean risks and the items chosen to operationalise not honest and not competent are selected from those that scored the highest assessed mean risks. Table 5.2 shows the summary of this analysis. Panel A of the table lists the ranking of the variables categorised as honest, Panel B ranks the variables categorised as not honest. Panels C and D in Table 5.2 show the ranking of the variables categorised as competent and not competent, respectively.

Table 5.2
Items from the Survey with the Highest and Lowest Mean Assessed Risks

Descriptions of Variables	Mean Assessed Risk
Panel A: ***Ranking of "not honest" items, where "contribution to risk" ratings are the highest***	
The financial director gives an instruction to delete valid accounts payable two months before the year end and reinstate them around middle of the financial year.	6.09
A significant amount of physical inventory is missing.	5.94
The CEO terminated the vice president and a director who questioned the CEO's action to capitalise start-up costs with the intention to maintain or increase the stock price and earnings.	5.66
Management approves non-related expenses (e.g., personal travelling expenses) as a company expenses.	5.38
Individuals related to the directors sell their shares in a subsidiary before the subsidiary was sold.	5.36
There have been adjustments showing a reduction in operating expenses and an increase in inventory on a monthly basis but no documentation exists to support these.	5.36
The sales manager sometimes made adjustments to the amounts of credit sales in writing on some of the carbon copies of sales vouchers.	5.13
There have been regular instructions from the chief accountant to transfer inventory to the equipment account.	5.08
Panel B: ***Ranking of "Honest" items, where "contribution to risk" ratings are the lowest***	
Directors are committed to attend the board of directors meetings and you observe that decision-making in these meetings is always thorough.	1.83
The financial controller tells the auditor his concern about a weakness in the control system.	3.72
Panel C: ***Ranking of "not competent" items, where "contribution to risk" ratings are the highest***	
Customers complain about overdue notices. They say they have paid and have receipts to prove it. The staff accountant is unable to locate records of the related accounts receivable.	5.69
The Financial Controller does not comply with GAAP on some material matters.	5.65
Expired inventory are still included in the valuation of inventory at full cost.	5.51
The accounts manager processes vouchers for payments without checking for authorisation.	5.14
The credit manager is unable to explain discrepancies between accounts receivable balances and debtors' confirmations.	5.12
Accounts payable and accounts receivable are not reconciled.	5.09
Sales orders received are recognised as sales immediately.	5.01
The senior accountant has been unable to provide a list of all fixed assets, asset identification numbers, cost, date of purchase, and current location of each item on the list. The excuse given is she has always been busy.	5.00
Panel D: ***Ranking of "competent" items, where "contribution to risk" ratings are the lowest***	
The chief accountant reduced the provision for doubtful debts because the company received, just before the year-end, a settlement from a substantial customer, whose account had been overdue for months.	2.99
The accounts manager is always ready with satisfactory answers when asked about fluctuations in revenue.	2.55
The CFO has a reputation of impeccable integrity and has won a CFO Excellence Award.	1.87
The CFO has more than 10 years of experience in the industry.	1.87
Directors are committed to attend the board of directors meetings and you observe that decision-making in these meetings is always thorough.	1.83

In describing the honesty and competency of client management, similar phrasing as used in the survey is used to avoid changes in auditors' perceptions of honesty (or dishonesty) and competency (or incompetency). In addition, the descriptions of the client behaviour that are chosen take into account the appropriateness of the circumstances in relation to the job of a financial controller who represents the client management in the case study. Finally, to avoid any bias that an honest (not honest) behaviour is stronger or weaker than a competent (not competent) behaviour, I selected cues with similar average scores for the "contribution to risk" ratings provided by the survey participants.

The cue chosen to operationalise honest behaviour in the case instrument is *"The financial controller tells the auditor his concern about a weakness in the control system"* (mean = 3.72). One of the cues chosen to operationalise the not honest behaviour of the financial controller is *"Management approves non-related expenses (e.g., personal travelling expenses) as a company expenses"* (mean = 5.38). Management is represented by the financial controller in the case instrument. Another cue, *"There have been adjustments showing a reduction in operating expenses and an increase in inventory on a monthly basis but no documentation exists to support these"* (mean = 5.36) is also chosen to operationalise financial controller dishonesty.

The cues chosen to describe the financial controller as competent are *"The CFO has a reputation of impeccable integrity and has won a CFO Excellence Award"* (mean = 1.87); and the *"The CFO has more than 10 years of experience in the industry"* (mean = 1.87). The word CFO is replaced by financial controller in the case instrument.

The cue that is chosen to describe the financial controller as not competent is *"The Financial Controller does not comply with GAAP on some material matters"* (mean = 5.65). This is represented by two different non-compliances; the revenue on sale was recognised even though the title of goods has not actually been transferred, and research costs were capitalised.

5.3 Audit Assertions

The dependent variables in this experiment are the auditors' assessments of the truth of audit assertions. Understanding risk assessments made at the assertion level is important to the understanding of audit risk assessments in general. Standard-setters and proponents of an assertion-level approach argue that it has the potential of creating a more efficient and effective linkage of assessed risk to planned audit work. There have been a few studies involving assertion-level risk assessments (Braun 2000; Mock and Wright 1993; Waller 1993), and findings from these studies indicate that auditors' evidential planning judgments are influenced by risk factor information at the assertion level. Similarly, Martinov and Roebuck (1998) suggest that understanding assertion-level risk assessments are relevant to understanding the audit approaches of audit firms.

In the experiment, the participants assess the truth of the assertions relating to completeness, cut-off, accuracy of cash transactions as the information provided in the experiment relates to these assertions. In addition, participants assess two other assertions on the overall truth and fairness of the cash transactions; and the overall cash and cash equivalent balances.

The next chapter presents the results from the behavioural experiment.

CHAPTER SIX

RESULTS FOR THE EXPERIMENT

6.1 Introduction

The chapter is structured as follows. Section 6.2 presents the demographic data of the participants. Following this, Section 6.3 reports the test of category-diagnosticity of the variables to ensure that the changes to the descriptions of financial controller's behaviour are correctly perceived by the auditors. Section 6.4 reports the effects of initial honesty and competency of the financial controller on auditors' assessments of audit assertions prior to additional information confirming or disconfirming management's honesty and competency. Section 6.5 reports the effects of consistent or inconsistent information about the honesty and competency of the financial controller on auditors' assessments of audit assertions. The analyses in this section are divided into two parts. The first part reports on the effects of consistent and inconsistent information about the honesty and competency of the financial controller on the revisions of auditors' assessments (i.e., the differences between auditors' initial and second assessments). The second part reports on the effects of consistent and inconsistent information about the honesty and competency of the financial controller on auditors' second assessments. Second assessments are the posterior assessments made by the participants after reading the additional information that is either consistent or inconsistent with the initial description about the honesty and competency of the financial controller. Finally, the last section provides a summary of the results.

6.2 The Participants

The experimental case materials were distributed to attendees of professional accounting and auditing training sessions in Australia. They are auditors and accountants receiving training as part of the preparation for their chartered accounting program exams. Participants were remunerated with a $20 gift voucher for their participation. A total of 199 instruments were completed and returned. Table 6.1 shows the demographic information of the participants. The number of female and male participants is almost the same. The average age is 24.3 years having an average of 13.3 months average audit experience. The majority (67.3 percent) work for a Big-4 firm. This means they have experience in various types of clients coming from various types of industries. Even though 88 (44.2 percent) are not currently working as auditors, they all have audit experience.

Table 6.1
Demographic Data

Gender	N	
Male	108	54.3%
Female	91	45.7%
Total	199	100.0%
Average Age		24.3 years
Maximum audit experience		180 months
Minimum audit experience		6 months
Average audit experience		13.3 months
Current position		
Audit staff	97	48.8%
Senior auditor	7	3.5%
Internal auditor	7	3.5%
Other	88	44.2%
Total	199	100.0%
Type of audit firm		
Big-4	134	67.3%
Medium size	37	18.6%
Small	7	3.5%
Other	21	10.6%
Total	199	100.0%

6.3 Category-diagnosticity Test

Independent *t-tests* were performed to ensure that the manipulations are seen as intended. The manipulation checks are to ensure that when the additional description of the behaviour of the financial controller changed from positive to negative and from negative to positive behaviours, the participants responded accordingly. This means the change from a description of honest to not honest behaviour is different from the change from a description of not honest to honest behaviour. Similarly, the change from a description of competent to not competent behaviour is perceived as different from the change from a description of not competent to competent behaviour. The participants are asked the questions: *"Please assess the level of honesty of the Financial Controller"* to assess their perceptions of honesty and *"Please assess the level of competency of the Financial Controller"* to assess their perceptions of competency. They are required to respond on a seven-point Likert scale, with '1' dishonest/incompetent and '7' honest/competent. The *t-tests* are used to test for significant differences in response to these questions. Table 6.2 below shows the results of the *t-tests*.

Table 6.2
"Honesty" and "Competency" Manipulation

		N	Mean	Std. Dev.	df	*t*	Sig.
Level of Honesty	Honest to not honest	65	2.154	1.556			
	Not honest to honest	50	3.520	1.474	113	-4.779	0.000
Level of Competency	Competent to not competent	71	0.732	1.309			
	Not competent to competent	60	1.833	2.226	129	-3.512	0.001

The results reported in Table 6.2 indicate that the manipulation of the honesty and competency of the financial controller is seen as intended by the participants. Auditors' assessments on the change of behaviour from honest to not honest are significantly different from the change of behaviour from not honest to honest. They are also significantly different when the description of the financial controller's behaviour changes from competent to not competent and from not competent to competent.

6.4 The Effects of the Honesty and Competency of Financial Controller on Auditors' Initial Assessments on Audit Assertions

Hypothesis 1a proposes that auditors' initial assessments of the truth of an audit assertion are higher when the initial information describes the financial controller as honest compared to when initial information describes them as not honest. Hypothesis 1b proposes that auditors' initial assessments of the truth of an audit assertion are higher when the initial information describes the financial controller as competent compared to when initial information describes him as not competent. Hypothesis 1c proposes that auditors' initial assessments of the truth of an audit assertion are affected by the interaction between the initial honesty and initial competency of the financial controller, i.e., the assessments on audit assertions will fall in between these extreme values when the financial controller is described as honest but not competent; or when he is described as not honest but competent. Table 6.3 shows the descriptive statistics for the auditors' initial assessments on the audit assertions based on the honesty and competency of the financial controller. These are the assessments made by the auditors before they received additional information either confirming or disconfirming the financial controller's initial honesty and initial competency.

Table 6.3
Descriptive Statistics on Auditors' Initial Assessments of Audit Assertions [mean and (standard deviation)]

Initial Behaviour	Initial Honest	Initial Not Honest	Initial Competent	Initial Not Competent	Initial Honest and Initial Competent	Initial Honest and Initial Not Competent	Initial Not Honest and Initial Competent	Initial Not Honest and Initial Not Competent
Assertion								
Completeness	3.021 (1.514) n = 97	2.588 (1.417) n = 102	3.029 (1.559) n=105	2.543 (1.341) n=94	3.177 (1.621) n = 51	2.848 (1.382) n = 46	2.889 (1.501) n = 54	2.250 (1.246) n = 48
Cut-off	2.680 (1.319) n = 97	2.373 (1.226) n = 102	2.543 (1.279) n=105	2.500 (1.285) n=94	2.882 (1.366) n = 51	2.457 (1.242) n = 46	2.222 (1.110) n = 54	2.542 (1.336) n = 48
Accuracy	2.268 (1.396) n =9 7	1.990 (1.324) n = 102	2.286 (1.459) n=105	1.947 (1.230) n=94	2.490 (1.515) n = 51	2.022 (1.220) n = 46	2.093 (1.391) n = 54	1.875 (1.248) n = 48
Overall cash transactions	2.464 (1.011) n = 97	2.265 (1.258) n = 102	2.495 (1.145) n=105	2.213 (1.135) n=94	2.667 (1.125) n = 51	2.239 (0.822) n = 46	2.333 (1.149) n = 54	2.188 (1.379) n = 48
Overall cash and cash equivalent balances	2.392 (1.253) n = 97	2.206 (1.253) n = 102	2.391 (1.088) n=105	2.192 (1.157) n=94	2.490 (1.065) n = 51	2.283 (0.834) n = 46	2.296 (1.110) n = 54	2.104 (1.403) n = 48

Variables:
Initial Honest (Not Honest) = the initial description of the financial controller's behaviour indicates he is honest (not honest). Initial Competent (Not Competent) = the initial description of the financial controller's behaviour indicates he is competent (not competent). Assertion: Subjects' initial assessments of the audit assertion (1 – "Strongly believe that the assertion is NOT true", and 7 – "Strongly believe that the assertion is true").

The first two columns of results in Table 6.3 report that, for each of the assertions, the average assessment is higher when the financial controller is described as honest compared to when he is described as not honest. Similarly, as shown in the columns reporting descriptive statistics for Initial Competent and Initial Not Competent, the average assessment is higher for each assertion when the financial controller is described as competent compared to when he is described as not competent.

For the completeness assertion, the average assessment is highest in the condition where the financial controller is described as both honest and competent (mean = 3.177). The average assessment is lowest when his initial behaviour is described as both not honest and not competent (mean = 2.250). Auditors' assessments do not differ much in conditions when the initial behaviour of the financial controller is coupled with another positive or negative behaviour, i.e., the financial controller is honest but not competent (mean = 2.848) or not honest but competent (mean = 2.889). Similar results are found for the accuracy assertion, overall cash transaction assertion and overall cash and cash equivalent balance assertion. For all of these assertions, the average initial assessments are highest when the financial controller is described as both honest and competent and they are lowest when the financial controller is described as both not honest and not competent. The initial average assessments fall between these two values when the financial controller is initially described as honest but not competent, or not honest but competent. The results indicate that auditors' initial assessments of whether an audit assertion is true or not true are affected by the initial information about the honesty and competency of the client's financial controller.

However, the results for the cut-off assertion are different. The assessment is highest for the condition where the financial controller is initially described as honest and competent (mean = 2.882). It should be lowest when the initial behaviour is both not honest and not competent (mean = 2.542). However, the lowest assessment is for the condition where the financial controller is described as not honest but competent (mean = 2.222).

Tables 6.4 and 6.5 report the MANOVA and ANOVA results for the auditors' initial assessments of the truth of the audit assertions based on the initial description of the honesty and competency of the financial controller (i.e., before they read the additional information that is either consistent or inconsistent with the initial description of his honesty and competency). The post hoc tests are performed using the Games-Howell test.[13]

Initial Honest has a significant main effect on the auditors' initial assessments of the audit assertions (MANOVA p-value = 0.080). However, the ANOVA results show that there is a significant main effect for the completeness (p-value = 0.017), cut-off (p-value = 0.056), and accuracy (p-value = 0.080) assertions, but no significant main effect for the two overall assertions. The p-values are 0.118 for the overall cash transaction assertion, and 0.122 for the overall cash and cash equivalent assertion.

[13] The Games-Howell test is powerful but can be liberal when sample sizes are small. It is accurate when sample sizes are unequal. The Games-Howell test is recommended because of the uncertainty of knowing whether the population variances are equivalent (Field 2005).

Therefore, Hypothesis 1a is supported for Initial Honest for the completeness, cut-off, and accuracy assertions, but not for the two overall assertions.

Table 6.4
MANOVA Results for Auditors' Initial Assessments of Audit Assertions Based on the Initial Honesty and Competency Descriptions of the Financial Controller

Effect	Pillai's Trace	F-statistics	Hypothesis df	Error df	p-value*
Initial Honest	0.037	2.445	3.000	193	0.080
Initial Competent	0.037	2.493	3.000	193	0.092
Interaction					
Initial Honest x Initial Competent	0.026	1.686	3.000	193	0.134

Box's test of equality of covariance matrices p = 0.006
**p-values are for one-tail tests.*
Variables:
Initial Honest = 1 if the behaviour of the financial controller is initially described as honest; 0 if not honest. Initial Competent = 1 if the behaviour of the financial controller is initially described as competent; 0 if not competent. Assertion: Subjects' initial assessments of the audit assertion (1 – "Strongly believe that the assertion is NOT true", and 7 – "Strongly believe that the assertion is true").

Table 6.5
ANOVA Results for Auditors' Initial Assessments of Audit Assertions Based on the Initial Honesty and Competency Descriptions of the Financial Controller

	SS	df	Mean Square	F-statistic	p-value*
Panel A: Completeness Assertion[a]					
Main Effects					
Initial Honest	9.714	1	9.714	4.624	0.017
Initial Competent	11.600	1	11.600	5.521	0.010
Interaction					
Initial Honest x Initial Competent	1.193	1	1.193	.568	0.226
Error	409.680	195	2.101		
Panel B: Cut-off Assertion[b]					
Main Effects					
Initial Honest	4.097	1	4.097	2.561	0.056
Initial Competent	0.140	1	0.140	0.088	0.384
Interaction					
Initial Honest x Initial Competent	6.883	1	6.883	4.302	0.020
Error	311.957	195	1.600		
Panel C: Accuracy Assertion[c]					
Main Effects					
Initial Honest	3.672	1	3.672	2.003	0.080
Initial Competent	5.832	1	5.832	3.181	0.038
Interaction					
Initial Honest x Initial Competent	0.780	1	0.780	0.425	0.258
Error	357.510	195	1.833		
Panel D: Overall Cash Transaction Assertion[d]					
Main Effects					
Initial Honest	1.836	1	1.836	1.415	0.118
Initial Competent	4.074	1	4.074	3.140	0.039
Interaction					
Initial Honest x Initial Competent	0.983	1	0.983	0.758	0.193
Error	253.015	1.298			
Panel E: Overall Cash and Cash Equivalent Balance Assertion[e]					
Main Effects					
Initial Honest	1.718	1	1.718	1.363	0.122
Initial Competent	1.980	1	1.980	1.571	0.106
Interaction					
Initial Honest x Initial Competent	0.003	1	0.003	0.002	0.481
Error	245.810	195	1.261		

[a]*Levene's test for equality of variances p=0.263* [b]*Levene's test for equality of variances p=0.400*
[c]*Levene's test for equality of variances p=0.333* [d]*Levene's test for equality of variances p=0.168*
[e]*Levene's test for equality of variances p=0.030*
**p-values are for one-tail tests.*
Variables:
Initial Honest = 1 if the behaviour of the financial controller is initially described as honest; 0 if not honest. Initial Competent = 1 if the behaviour of the financial controller is initially described as competent; 0 if not competent. Assertion: Subjects' initial assessments of the audit assertion (1 – "Strongly believe that the assertion is NOT true", and 7 – "Strongly believe that the assertion is true").

Initial Competent also has a significant main effect on auditors' assessments of audit assertions (MANOVA p-value = 0.092). However, the ANOVA results show that Initial Competent has a significant main effect on the completeness, accuracy and overall cash transaction assertions, where the p-value is 0.010 for the completeness assertion; 0.038 for the accuracy assertion; and 0.039 for the overall cash transaction assertion, but Initial Competent does not have a significant main effect on the cut-off (p-value = 0.384) and the overall cash and cash equivalent balance (p-value = 0.106) assertions. Therefore, Hypothesis 1b is supported for Initial Competent for the completeness, accuracy and overall cash transactions assertions, but not for the cut-off and the overall cash and cash equivalent balance assertions.

The MANOVA result indicates there is no significant interaction effect between Initial Honest and Initial Competent (p-value = 0.134). However, the interaction effect is significant for the cut-off assertion (ANOVA p-value = 0.020). It is not significant for the other assertions, where the p-values are 0.226 for the completeness assertion, 0.258 for the accuracy assertion, 0.193 for the overall cash transaction assertion, and 0.481 for the overall cash and cash equivalent balance assertion. Figure 6.1 shows the significant interaction between the descriptions of the financial controller's initial honesty and initial competency.

Figure 6.1
The Interaction Effect between Initial Honesty and Initial Competency of the Financial Controller on Auditors' Initial Assessments for the Cut-off Assertion

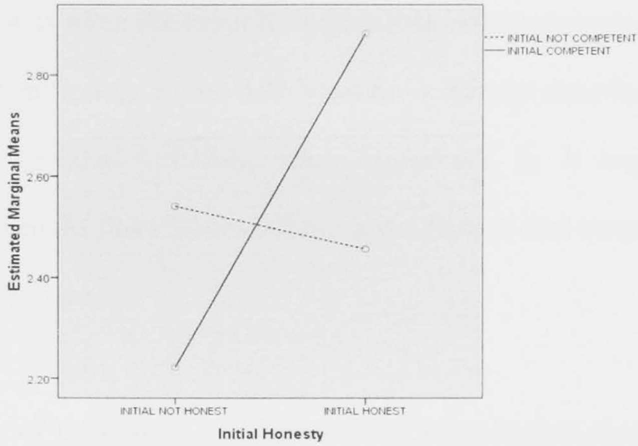


Table 6.6
Post Hoc Tests for Auditors' Initial Assessments of Audit Assertions Based on the Initial Honesty and Competency of the Financial Controller for the Cut-off Assertion (Games-Howell test)

(I)	(J)	Mean Difference (I-J)	Std. Error	Sig.*
Initial Honest and Initial Competent	Initial Honest and Initial Not Competent	0.426	0.265	0.190
	Initial Not Honest and Initial Competent	0.660	0.244	0.020
	Initial Not Honest and Initial Not Competent	0.340	0.272	0.297
Initial Honest and Initial Not Competent	Initial Honest and Initial Competent	-0.426	0.265	0.190
	Initial Not Honest and Initial Competent	0.234	0.237	0.379
	Initial Not Honest and Initial Not Competent	-0.085	0.266	0.495
Initial Not Honest and Initial Competent	Initial Honest and Initial Competent	-0.660	0.244	0.020
	Initial Honest and Initial Not Competent	-0.234	0.237	0.379
	Initial Not Honest and Initial Not Competent	-0.319	0.245	0.282
Initial Not Honest and Initial Not Competent	Initial Honest and Initial Competent	-0.341	0.273	0.297
	Initial Honest and Initial Not Competent	0.085	0.266	0.495
	Initial Not Honest and Initial Competent	0.319	0.245	0.282

* *p-values are for one-tail tests.*

Initial Honest (Not Honest) indicates the initial description of the financial controller indicates he is honest (not honest). Initial Competent (Not Competent) indicates the inital description of the financial contoller indicates he is competent (not competent).

Table 6.6 shows the results of the Games-Howell tests for the interaction effect for the cut-off assertion. The results from the Games-Howell tests indicate that the average assessments when the financial controller is initially described as honest and competent are significantly higher than when he is initially described as not honest and competent (p-value = 0.020). Thus, Hypothesis 1c is supported for the interaction between the financial controller's initial honesty and competency but only for the cut-off assertion.

6.5 The Effects of Consistent and Inconsistent Information about the Honesty and Competency of Financial Controller on Auditors' Assessments of the Audit Assertions

6.5.1 Differences between Auditors' Initial and Second Assessments

Studies testing the impression formation theories have found that people are affected more by the morality rather than the intelligence of an individual in forming an impression of that individual. As such, they are negatively biased in perceiving honesty and positively biased in perceiving competency due to the greater diagnosticity of morality cues as predicted by the category-diagnosticity theory.

Therefore, it is proposed that the revisions to the assessments of the truth of an audit assertion will be negative or negative and larger when the financial controller is consistently described as not honest or not competent than when management is consistently described as honest or competent (Hypothesis 2a). Hypothesis 2b posits that the revisions to the assessments of the truth of an audit assertion will be negative or negative and larger when the financial controller is initially described as honest or competent and is subsequently described as not honest or not competent than when he is initially described as not honest or not competent and is subsequently described as honest or competent.

Further, Hypothesis 2c proposes that the revisions to the assessments of the truth of an assertion will be negative or negative and larger when the financial controller is initially described as honest or competent and is subsequently described as not honest or not competent than when he is described as consistently honest or consistently competent. Hypothesis 2d proposes that the revisions to the assessments of the truth of an assertion will be negative or negative and larger when the financial controller is consistently described as not honest or consistently described as not competent than when he is initially described as not honest or not competent and is subsequently described as honest or competent.

Tables 6.7 and 6.8 show the descriptive statistics for the differences between auditors' initial assessments and second assessments. The independent variables are the consistency and inconsistency of the descriptions of honesty and competency of the financial controller. It is noted that auditors make small revisions to their assessments, where the revisions of the assessment means are all less than 1.00.

Table 6.7

Descriptive Statistics on the Differences between Auditors' Initial and Second Assessments of Audit Assertions Based on Consistent or Inconsistent Information about the Honesty and Competency of the Financial Controller [mean (standard deviation)]

Initial Behaviour	Consistent Honest and Inconsistent Competent	Inconsistent Honest and Consistent Competent	Inconsistent Honest and Inconsistent Competent
Panel A: Completeness Assertion			
Initial Honest and Initial Competent	-0.177 (2.038) n=17	-0.375 (1.586) n=16	-0.333 (1.645) n = 18
Initial Honest and Initial Not Competent	0.267 (1.668) n = 15	-0.529 (1.841) n = 17	-0.071 (1.072) n = 14
Initial Not Honest and Initial Competent	-0.667 (1.572) n = 18	0.579 (1.261) n = 19	-0.294 (1.829) n = 17
Initial Not Honest and Initial Not Competent	-0.353 (1.455) n = 17	0.529 (1.546) n = 17	0.429 (0.756) n = 14
Panel B: Cut-off Assertion			
Initial Honest and Initial Competent	-0.588 (1.121) n = 17	-0.125 (0.619) n = 16	-0.389 (1.539) n = 18
Initial Honest and Initial Not Competent	0.467 (1.187) n = 15	0.118 (0.857) n = 17	0.143 (1.231) n = 14
Initial Not Honest and Initial Competent	-0.111 (1.278) n = 18	0.421 (1.121) n = 19	-0.706 (1.160) n = 17
Initial Not Honest and Initial Not Competent	-0.588 (1.417) n = 17	0.235 (1.033) n = 14	0.071 (0.730) n = 14
Panel C: Accuracy Assertion			
Initial Honest and Initial Competent	0.706 (1.795) n = 17	-0.563 (1.632) n = 16	0.500 (1.425) n = 18
Initial Honest and Initial Not Competent	0.333 (2.350) n = 15	0.000 (0.935) n = 17	0.357 (1.393) n = 14
Initial Not Honest and Initial Competent	-0.167 (1.425) n = 18	0.684 (1.003) n = 19	0.941 (1.197) n = 17
Initial Not Honest and Initial Not Competent	-0.059 (1.819) n = 17	0.412 (1.417) n = 17	0.857 (1.099) n = 14

Table 6.7 (continued)

Initial Behaviour	Consistent Honest and Inconsistent Competent	Inconsistent Honest and Consistent Competent	Inconsistent Honest and Inconsistent Competent
Panel D: Overall Cash Transaction Assertion			
Initial Honest and Initial Competent	0.118 (0.781) n=17	-0.250 (1.571) n=16	-0.222 (1.166) n = 18
Initial Honest and Initial Not Competent	0.467 (1.302) n=15	-0.118 (0.697) n = 17	0.143 (1.099) n = 14
Initial Not Honest and Initial Competent	-0.222 (1.060) n = 18	0.579 (1.346) n = 19	0.294 (0.985) n = 17
Initial Not Honest and Initial Not Competent	-0.412 (1.417) n = 17	0.118 (1.219) n = 17	0.571 (0.938) n = 14
Panel E: Overall Cash and Cash Equivalent Balance Assertion			
Initial Honest and Initial Competent	0.177 (0.809) n = 17	0.438 (1.504) n = 16	-0.222 (1.003) n = 18
Initial Honest and Initial Not Competent	0.267 (1.100) n = 15	-0.294 (0.849) n = 17	0.000 (1.038) n = 14
Initial Not Honest and Initial Competent	-0.111 (1.132) n = 18	0.526 (1.219) n = 19	0.235 (1.091) n = 17
Initial Not Honest and Initial Not Competent	-0.177 (0.529) n = 17	0.059 (1.088) n = 17	0.5000 (1.019) n = 14

Variables:

Initial Honest (Not Honest) = the behaviour of the financial controller is initially described as honest (not honest). Initial Competent (Not Competent) = the behaviour of the financial controller is initially described as competent (not competent). Consistent (Inconsistent) = the second set of information about the financial controller is consistent (inconsistent) with the initial description of his behaviour. Assertion = Difference between the auditors' first and second assessments of the audit assertion (1 – "Strongly believe that the assertion is NOT true", and 7 – "Strongly believe that the assertion is true").

Table 6.8

Descriptive Statistics on the Differences between Auditors' Initial and Second Assessments of Audit Assertions Based on Information about the Consistency of Honesty and Competency of the Financial Controller [mean (standard deviation)]

Behaviour	Consistent Honest	Consistent Not Honest	Consistent Competent	Consistent Not Competent	Not Consistent Honest	Not Consistent Not Honest	Not Consistent Competent	Not Consistent Not Competent
Assertion								
Completeness	-0.254 (1.691) n = 67	-0.008 (1.526) n = 132	0.073 (1.612) n = 69	-0.177 (1.567) n = 130	-0.339 (1.554) n = 65	0.030 (1.589) n = 134	-0.371 (1.746) n = 70	0.062 (1.472) n = 129
Cut-off	-0.224 (1.301) n = 67	-0.167 (1.205) n = 132	0.174 (0.939) n = 69	-0.377 (1.331) n = 130	-0.354 (1.280) n = 65	-0.105 (1.209) n = 134	-0.700 (1.344) n = 70	0.093 (1.079) n = 129
Accuracy	0.194 (1.844) n = 67	0.402 (1.324) n = 132	0.159 (1.324) n = 69	0.423 (1.608) n = 130	0.077 (1.395) n = 65	0.455 (1.564) n = 134	0.486 (1.501) n = 70	0.248 (1.526) n = 129
Overall cash transactions	-0.030 (1.180) n = 67	0.136 (1.171 n = 132	0.101 (1.262) n = 69	0.069 (1.129) n = 130	-0.123 (1.153) n = 65	0.179 (1.175) n = 134	-0.014 (1.014) n = 70	0.132 (1.252) n = 129
Overall cash and cash equivalent balances	0.030 (0.152) n = 67	0.921 (1.129) n = 132	0.188 (1.204) n = 69	0.069 (0.982) n = 130	-0.031 (1.132) n = 65	0.179 (1.025) n = 134	0.014 (1.014) n = 70	0.163 (1.088) n = 129

Consistent Honest (Not Honest) indicates both the initial and second descriptions of the financial controller indicate he is honest (not honest). Consistent Competent indicates both the initial and second descriptions of the financial controller indicate he is competent (not competent). Not Consistent Honest indicates the initial description of the financial controller indicates he is honest and the second description indicates he is not honest. Not Consistent Not Honest indicates the initial description of the financial controller indicates he is not honest and the second description indicates he is honest. Not Consistent Competent indicates the initial description of the financial controller indicates he is competent and the second description indicates he is not competent. Not Consistent Not Competent indicates the initial description of the financial controller indicates he is not competent and the second description indicates he is competent.

Hypothesis 2a proposes that there will be negative or negative and larger revision to auditors' assessments on the truth of an audit assertion when the financial controller is consistently described as not honest or not competent than when he is consistently described as honest or competent. Thus, we are comparing the conditions where the financial controller is consistently described as not honest (or not competent) with the conditions where he is consistently described as honest (or competent). Consistently not honest (or not competent) is the condition where the financial controller is initially described as not honest (or not competent) and then the additional information describes him as not honest (or not competent). Consistent honest (or competent) is where the financial controller is initially described as honest (or competent) and then the additional information also describes him as honest (or competent). I expect that the revisions to auditors' assessments are larger for the conditions where the financial controller is consistently described as not honest (or not competent) than the revisions for the conditions where the financial controller is consistently described as honest (or competent). The average revisions reported in Table 6.8 do not have this consistent pattern. For example, for the completeness, cut-off and overall cash transactions assertions, Consistent Honest has larger average negative revisions than Consistent Not Honest. For the accuracy and overall cash and cash equivalent balances assertions, Consistent Not Honest has larger average positive revisions than Consistent Honest.

From Table 6.7, for the conditions where the financial controller is initially described as competent and is subsequently described as not competent, the average revisions to the assessments are -0.667, -0.111, -0.167, -0.222, and -0.111 respectively for the completeness, cut-off, accuracy, overall cash transaction, and overall cash and cash equivalent balance assertions when the financial controller is consistently described as not honest. When the financial controller is consistently described as honest, the average revisions to the assessments are -0.177, -0.588, 0.706, 0.118 and 0.177 respectively for the five assertions. Consistent descriptions of the financial controller as not honest cause negative revisions for all the assertions, while consistent descriptions of the financial controller as honest cause positive revisions.

For the conditions where the financial controller is initially described as not competent and is subsequently described as competent, consistent not honest descriptions result in average revisions of -0.353, -0.588, -0.059, -0.412 and -0.177 respectively for the completeness, cut-off, accuracy, overall cash transaction, and overall cash and cash equivalent balance assertions; while consistent descriptions indicating that the financial controller is honest result in average revisions of 0.267, 0.467, 0.333, 0.467 and 0.267 respectively for all the assertions. Consistent descriptions of the financial controller as not honest result in negative revisions, and consistent descriptions of him as honest result in positive revisions.

With regard to competency, for the conditions where the financial controller is initially described as honest and subsequently as not honest, consistent descriptions of the financial controller as not competent result in average revisions of -0.529, 0.118, 0.000, -0.118 and -0.294 respectively for the completeness, cut-off, accuracy, overall cash transaction, and overall cash and cash equivalent balance assertions; while consistent descriptions of the financial controller as competent result in average revisions of -0.375, -0.125, -0.563, -0.250 and 0.438 respectively for all the assertions. The completeness, overall cash transaction, and overall cash and cash equivalent balance assertions result in negative revisions when the financial controller is consistently described as not competent, and only the completeness assertion results in a negative and larger revision.

For the conditions where the financial controller is initially described as not honest and subsequently as honest, consistent descriptions of the financial controller as not competent result in positive average revisions of 0.529, 0.235, 0.412, 0.118 and 0.059 respectively for the completeness, cut-off, accuracy, overall cash transaction, and overall cash and overall cash equivalent balance assertions. Being described as honest seems to have a greater impact than being described as not competent. The average revisions are also positive when the financial controller is consistently described as competent (mean revisions = 0.579, 0.421, 0.684, 0.579 and 0.526 respectively for all the assertions).

Hypothesis 2b proposes that there will be negative revisions or negative and larger revisions to the auditors' assessments when the financial controller is not consistently described as honest or competent (i.e., the financial controller is initially described as honest or competent and subsequently as not honest or not competent), than when he is not consistently described as not honest or not competent (i.e., the financial controller is initially described as not honest or not competent and subsequently as honest or competent).

With regard to honesty, for the conditions where the financial controller is consistently described as competent and he is initially described as honest and subsequently as not honest, this results in average revisions of -0.375, -0.125, -0.563, -0.250 and 0.438 respectively for the completeness, cut-off, accuracy, overall cash transaction, and overall cash and cash equivalent balance assertions. When the financial controller is initially described as not honest and subsequently as honest, this results in positive average revisions of 0.579, 0.421, 0.684, 0.579 and 0.526 respectively for all the assertions. Initial descriptions of the financial controller as honest and subsequently as not honest results in negative, but not necessarily larger revisions than when he is initially described as not honest and subsequently as honest, except for the overall cash and cash equivalent balance assertion, where consistent dishonesty results in positive average revision.

For the conditions where the financial controller is consistently described as not competent, inconsistent descriptions about the honesty of the financial controller (i.e., the financial controller is initially described as honest and subsequently as not honest) result in average revisions of -0.529, 0.118, 0.000, -0.118 and -0.294 respectively for the completeness, cut-off, accuracy, overall cash transaction, and overall cash and cash equivalent balance assertions. The average revisions are 0.529, 0.235, 0.412, 0.118 and 0.059 respectively for the five assertions when the financial controller is initially described as not honest and he is subsequently described as honest. The average revisions are positive for all the assertions despite the fact that the financial controller is consistently described as not competent. The overall cash transaction, and overall cash and cash equivalent balance assertions result in negative revisions; and only the overall cash and cash equivalent balance assertion results in a negative and larger revision.

With regard to competency, for the conditions where the financial controller is consistently described as honest, inconsistent descriptions about the competency of the financial controller (i.e., the financial controller is initially described as competent and subsequently as not competent), the average revisions are -0.177, -0.588, 0.706, 0.118 and 0.177 respectively for the completeness, cut-off, accuracy, overall cash transaction, and overall cash and cash equivalent balance assertions. The average revisions are positive when the financial controller is initially described as not competent and subsequently as competent (average revisions = 0.267, 0.467, 0.333, 0.467 and 0.267 respectively for all the assertions). Only the completeness and cut-off assertions result in negative, but not necessarily larger revisions, when the financial controller is initially described as competent and subsequently as not competent.

For the conditions where the financial controller is consistently described as not honest, the average revisions are -0.667, -0.111, -0.167, -0.222 and -0.111 respectively for the completeness, cut-off, accuracy, overall cash transaction, and overall cash and cash equivalent balance assertions when the financial controller is initially described as competent and subsequently as not competent. For the conditions where the financial controller is initially described as not competent and subsequently as competent, the average revisions are also negative for all the assertions (average revisions = -0.353, -0.588, -0.059, -0.412 and -0.177 respectively for all assertions).

Hypothesis 2c proposes that when the financial controller is initially described as honest or competent and subsequently as not honest or not competent (inconsistent honesty and inconsistent competency), this will result in negative revisions or negative and larger revisions to the auditors' assessments of the assertions than when the financial controller is consistently described as honest or consistently described as competent.

With regard to honesty, for the conditions where the financial controller is initially described as competent and subsequently as not competent, inconsistent descriptions of the financial controller's honesty (i.e., the financial controller is initially described as honest and subsequently as not honest) result in average revisions of -0.333, -0.389, 0.500, -0.222 and -0.222 respectively for the completeness, cut-off, accuracy, overall cash transaction, and overall cash and cash equivalent balance assertions. The average revisions are -0.177, -0.588, 0.706, 0.118 and 0.177 respectively for all the assertions when financial controller is consistently described as honest. The results are mixed for these conditions, where the completeness, overall cash transaction, and overall cash and cash equivalent balance assertions result in negative and larger revisions, while the cut-off assertion results in negative but smaller revision.

For the conditions where the financial controller is initially described as not competent and honest and he is subsequently described as competent and not honest, the average revisions are -0.071, 0.143, 0.357, 0.143 and 0.000 respectively for the completeness, cut-off, accuracy, overall cash transaction, and overall cash and cash equivalent balance assertions. Consistently describing the financial controller as honest results in average revisions of 0.267, 0.467, 0.333, 0.467 and 0.267 respectively for all the five assertions. Only the completeness assertion results in an average negative revision. For these conditions, competency seems to have a greater impact because almost all revisions are positive.

With regard to competency, for the conditions when the financial controller is initially described as honest and competent and subsequently as not honest and not competent, the average revisions are -0.333, -0.389, 0.500, -0.222 and -0.222 respectively for the completeness, cut-off, accuracy, overall cash transaction, and overall cash and cash equivalent balance assertions. Except for the accuracy assertion, there are negative revisions for the other assertions when the financial controller is initially described as honest and subsequently as not honest. When the financial controller is consistently described as competent, the average revisions are -0.375, -0.125, -0.563, -0.250 and 0.438 respectively for all the assertions. Only the cut-off assertion results in a negative and larger revision when the financial controller is initially described as honest and subsequently as not honest compared to when financial controller is consistently described as competent. Being described as not honest and not competent seem to have a greater impact on auditors' assessments as most of the revisions are negative.

For the conditions where the financial controller is initially described as not honest and subsequently as honest, the average revisions are -0.294, -0.706, 0.941, 0.294 and 0.235 respectively for the completeness, cut-off, accuracy, overall cash transaction, and overall cash and cash equivalent balance assertions when the financial controller is initially described as competent and subsequently as not competent. Only the completion and cut-off assertions result in average negative revisions. The mean revisions are 0.579, 0.421, 0.684, 0.579 and 0.526 respectively for the five assertions when the financial controller is consistently described as competent. For these conditions, honesty and competency seem to have a greater impact on the auditors' revisions to their assessments as most of the revisions are positive.

Hypothesis 2d proposes that there will be negative or negative and larger revisions of assessments of the truth of an audit assertion when the financial controller is consistently described as not honest or not competent than when financial controller is initially described as not honest or not competent and is subsequently described as honest or competent.

With regard to honesty, for the conditions where the financial controller is initially described as competent and subsequently as not competent, the average revisions are -0.667, -0.111, -0.167, -0.222 and -0.111 respectively for the completeness, cut-off, accuracy, overall cash transaction, and overall cash and cash equivalent balance assertions when the financial controller is consistently described as not honest. When the financial controller is initially described as not honest and subsequently described as honest, the average revisions are -0.294, -0.706, 0.941, 0.294 and 0.235. The revisions for all the assertions are negative when the financial controller is consistently described as not honest. The results show that auditors' assessments may be influenced by the description of a financial controller who is not honest.

For the conditions where the financial controller is initially described as not competent and subsequently described as competent, the average revisions are -0.353, -0.588, -0.059, -0.412 and -0.177 respectively for the completeness, cut-off, accuracy, overall cash transaction, and overall cash and cash equivalent balance assertions when financial controller is consistently described as not honest. The average revisions are 0.429, 0.071, 0.857, 0.571 and 0.500 respectively for the five assertions when the financial controller is initially described as not honest and subsequently described as honest. For these conditions, the revisions for all the assertions are negative when financial controller is consistently described as not honest and they are positive when financial controller is consistently described as competent.

This provides evidence that auditors' assessments are negative or negative and larger when the financial controller is consistently described as not honest than when they are initially described as not honest and subsequently as honest. It is also noted here that for all the assertions, when the financial controller is consistently described as not honest, the average revisions are negative but not necessarily larger than when he is initially described as not honest and subsequently as honest.

With regard to competency, for the conditions where the financial controller is initially described as honest and subsequently described as not honest, the average revisions are -0.529, 0.118, 0.000, -0.118 and -0.294 when he is consistently described as not competent. This provides evidence that auditors' assessments are influenced by the initial description of the financial controller being honest for the cut-off and accuracy assertions because the average revisions are positive or constant despite the fact that the financial controller is consistently described as not competent. The average revisions are -0.071, 0.143, 0.357, 0.143 and 0.000 when the financial controller is initially described as not competent and subsequently described as competent. Only the completeness, and the overall cash and cash equivalent balance assertions result in negative and larger revisions when the financial controller is described as consistently not competent.

For the conditions where the financial controller is initially described as not honest and subsequently described as honest, the average revisions are 0.529, 0.235, 0.412, 0.118 and 0.059 when the financial controller is consistently described as not competent. Here, honesty has a greater impact on auditors' assessments than dishonesty and incompetency because the revisions are positive for all the assertions even though the financial controller is consistently described as not competent. The average revisions are 0.429, 0.071, 0.857, 0.571 and 0.500 when the financial controller is initially described as not competent and subsequently described as competent.

In summary, the results are mixed. There seems to be evidence of negative and greater revisions to auditors' assessments when the financial controller is consistently described as not honest or consistently described as not competent. However, this does not hold for all the conditions for all the audit assertions. Nevertheless, it should be noted that honesty or dishonesty seems to have a greater impact than competency or incompetency in most of the conditions.

Category-diagnosticity theory proposes that people are negatively biased in perceiving honesty and positively biased in perceiving competency. Hypothesis 3a posits that auditors' revisions to the assessments of an audit assertion will be positive or positively larger when there is a consistent description of the financial controller as competent and when there is a positive revision to competency (i.e., when the financial controller is initially described as not competent and subsequently described as competent) than their revisions when there is consistent honesty and when there is a positive change to dishonesty (i.e., when the financial controller is initially described as not honest and subsequently described as honest). Further, Hypothesis 3b posits that auditors' revisions to the assessments of an audit assertion will be negative or negative and larger when the financial controller is consistently described as not honest and when there is a negative change to honesty (i.e., the financial controller is initially described as honest and subsequently described as not honest) than their revision when he is consistently described as not competent and when there is a negative change to competency (i.e., the financial controller is initially described as competent and subsequently described as not competent).

Table 6.6 reports that the average revisions to the assessments about the truth of the assertions are 0.579, 0.421, -0.684, 0.579 and 0.526 respectively for the completeness, cut-off, accuracy, overall cash transaction, and overall cash and cash equivalent balance assertions for the condition where the financial controller is consistently described as competent and there is a positive change to dishonesty, i.e., the financial controller is initially described as competent but not honest and subsequently as both competent and honest. The average revisions are positive for all the assertions (mean revisions = 0.267, 0.467, 0.333, 0.467 and 0.267 respectively) when the financial controller is consistently described as honest and there is a positive change to incompetency, i.e., the financial controller is initially described as honest but not competent and subsequently described as both honest and competent. Except for the accuracy assertion, auditors revise their assessments upward when the financial controller is consistently described as competent or consistently described as honest and there is a positive revision to the description of his incompetency or dishonesty.

For the conditions where the financial controller is consistently described as not honest and there is a negative revision to the description of his competency (i.e., the financial controller is initially described as not honest and competent, and subsequently described as both not honest and not competent), the average revisions are negative for all the assertions (mean revisions = -0.667, -0.111, -0.167, -0.222, and -0.111 respectively for the completeness, cut-off, accuracy, overall cash transaction, and overall cash and cash equivalent balance assertions). The average revisions are mixed when the financial controller is consistently described as not competent and there is a negative revision to the description of his honesty, i.e., the financial controller is initially described as not competent but honest and subsequently described as both not competent and not honest (mean revisions = -0.529, 0.118, 0.000, -0.111, -0.294 respectively). The average revisions are negative and larger for the completeness, accuracy and overall cash transaction assertions.

For the conditions where the financial controller is consistently described as competent and there is a negative change to honesty, i.e., the financial controller is initially described as both competent and honest and is subsequently described as competent but not honest, the average revisions are -0.375, -0.125, -0.563, -0.250 and 0.438 respectively for the completeness, cut-off, accuracy, overall cash transaction, and overall cash and cash equivalent balance assertions. The average revisions are -0.177, -0.588, 0.706, 0.118 and 0.177 respectively for the completeness, cut-off, accuracy, overall cash transaction, and overall cash and cash equivalent balance assertions for the conditions where the financial controller is consistently described as honest and there is a negative change to competency, i.e., the financial controller is initially described as both honest and competent and is subsequently described as honest but not competent. It is noted here that only the overall cash and cash equivalent balance assertion results in positive and larger revision when the financial controller is consistently described as honest than when the financial controller is consistently described as competent. For the other assertions, a negative change to honesty (i.e., the financial controller is initially described as honest and subsequently described as not honest) has a greater impact as it results in negative revisions.

The average revisions are negative for all the assertions (mean revisions = -0.353, -0.588, -0.059, -0.412 and -0.177 respectively for the completeness, cut-off, accuracy, overall cash transaction, and overall cash and cash equivalent balance assertions) when the financial controller is consistently described as not honest and there is a positive change to incompetency (i.e., the financial controller is initially described as both not honest and not competent and subsequently described as not honest but competent). However, they are not necessarily larger compared to the average revisions when the financial controller is consistently described as not competent and there is a positive change to dishonesty (i.e., the financial controller is initially described as both not competent and not honest and subsequently described as not competent but honest). For this condition, the average revisions are positive for all the assertions (mean revisions = 0.529, 0.235, 0.412, 0.118 and 0.059 respectively). Consistently describing the financial controller as not honest has a greater impact on the auditors' assessments than consistently describing him as not competent because the average revisions are all negative even though there is a positive change to incompetency (i.e., the financial controller is initially described as not competent and subsequently described as competent). Honesty has a greater impact than incompetency because a positive change to dishonesty (i.e., the financial controller is initially described as not honest and subsequently described as honest) results in positive average revisions for all the assertions despite the financial controller being consistently described as not competent.

For the condition where there is a positive change to incompetency and a negative change to honesty (i.e., the financial controller is initially described as not competent but honest and subsequently described as competent but not honest), the average revisions are -0.071, 0.143, 0.357, 0.143 and 0.000 respectively for the completeness, cut-off, accuracy, overall cash transaction, and overall cash and cash equivalent transactions. The average revisions are -0.294, -0.706, 0.941, 0.294 and 0.235 respectively, when there is a positive change to dishonesty and a negative change to competency (i.e., the financial controller is initially described as not honest but competent and subsequently described as honest but not competent). The results are mixed for the accuracy, overall cash transaction, and overall cash and cash equivalent balance assertions, where a positive change to dishonesty (i.e., the financial controller is initially described as not honest and subsequently described as honest) results in average revisions that are positive and larger than a positive change to incompetency (i.e., the financial controller is initially described as not competent and subsequently described as competent). For the completeness and cut-off assertions, a negative change to competency results in negative and larger revisions than a negative change to honesty.

In summary, the results in testing the positivity bias in auditors' judgments of competency and negativity bias in auditors' judgments of honesty are not consistent. There seems to be evidence of a negativity bias in auditors' judgments of honesty and a positivity bias in auditors' judgments of competency. However, this is not consistent for all the conditions for all of the audit assertions.

Tables 6.9 and 6.10 report the MANOVA and ANOVA results for the differences between auditors' initial and second assessments. The Games-Howell post hoc tests reported in Table 6.11 are carried out following the multivariate analyses for significant interaction effects in the ANOVAs. For brevity, only the results for the Games-Howell tests that are significant are reported in Table 6.11.

Table 6.9
MANOVA Results for the Differences between Auditors' Initial and Second Assessments of Audit Assertions

	Pillai's Trace	F	Hypothesis df	Error df	p-value*
Initial Honest	0.007	0.462	3	185	0.355
Initial Competent	0.032	2.020	3	185	0.057
Consistent Honest	0.037	2.373	3	185	0.036
Consistent Competent	0.103	7.102	3	185	0.000
Initial Honest x Initial Competent	0.043	2.741	3	185	0.023
Initial Honest x Consistent Honest	0.032	2.006	3	185	0.058
Initial Honest x Consistent Competent	0.010	0.653	3	185	0.291
Initial Competent x Consistent Honest	0.027	1.703	3	185	0.084
Initial Competent x Consistent Competent	0.059	3.846	3	185	0.006
Initial Honest x Initial Competent x Consistent Honest	0.010	0.632	3	185	0.298
Initial Honest x Initial Competent x Consistent Competent	0.007	0.427	3	185	0.367

Box's test of equality of covariance matrices p = 0.000
**p-values are for one-tail tests.*
Variables:
Initial Honest = 1 if the behaviour of the financial controller is initially described as honest; 0 if not honest. Initial Competent = 1 if the behaviour of the financial controller is initially described as competent; 0 if not competent. Consistent = 1 if the second set of information about the financial controller is consistent with the initial behaviour; 0 if the second set of information about financial controller is inconsistent with his initial behaviour. Assertion = Difference between the auditors' first and second assessments of the audit assertions (1 – "Strongly believe that the assertion is NOT true", and 7 – "Strongly believe that the assertion is true").

Table 6.10

ANOVA Results for the Differences between Auditors' Initial and Second Assessments of Audit Assertions

	Completeness Assertion[a]					Cut-off Assertion[b]					Accuracy Assertion[c]					Overall Cash Transaction Assertion					Overall Cash and Cash Equivalent Balance Assertion				
	SS	df	Mean Square	F	Sig.*	SS	df	Mean Square	F	Sig.*	SS	df	Mean Square	F	Sig.*	SS	df	Mean Square	F	Sig.*	SS	df	Mean Square	F	Sig.*
Initial Honest	2.561	1	2.561	1.036	0.155	0.286	1	0.286	0.218	0.321	1.391	1	1.391	0.621	0.216	0.189	1	2.561	0.140	0.354	0.067	1	0.067	0.060	0.403
Initial Competent	2.035	1	2.035	0.823	0.183	5.962	1	5.962	4.543	0.017	0.014	1	0.014	0.006	0.468	0.043	1	0.043	0.032	0.430	1.614	1	1.614	1.447	0.115
Consistent Honest	0.874	1	0.874	0.354	0.277	2.258	1	2.258	1.721	0.096	6.823	1	6.823	3.047	0.042	1.405	1	1.405	1.044	0.154	0.257	1	0.257	0.231	0.316
Consistent Competent	0.459	1	0.459	0.186	0.334	13.057	1	13.057	9.950	0.001	9.189	1	9.189	4.103	0.022	0.427	1	0.427	0.317	0.287	0.095	1	0.095	0.085	0.386
Interactions																									
Initial Honest x Initial Competent	0.079	1	0.079	0.032	0.429	10.177	1	10.177	7.755	0.003	0.197	1	0.197	0.088	0.384	2.567	1	2.567	1.914	0.084	0.031	1	0.031	0.028	0.434
Initial Honest x Consistent Honest	5.470	1	5.470	2.214	0.069	2.846	1	2.846	2.168	0.072	9.788	1	9.788	4.370	0.019	9.413	1	9.413	6.995	0.005	5.733	1	5.733	5.143	0.012
Initial Honest x Consistent Competent	4.431	1	4.431	1.793	0.091	0.006	1	0.006	0.004	0.474	1.050	1	1.050	0.469	0.247	0.029	1	0.029	0.022	0.442	0.543	1	0.543	0.487	0.243
Initial Competent x Consistent Honest	0.104	1	0.104	0.042	0.419	6.030	1	6.030	4.595	0.017	0.003	1	0.003	0.001	0.486	0.469	1	0.469	0.349	0.278	0.430	1	0.430	0.385	0.268
Initial Competent x Consistent Competent	2.883	1	2.883	1.167	0.141	10.351	1	10.351	7.888	0.003	0.545	1	0.545	0.243	0.311	1.925	1	1.925	1.431	0.167	5.801	1	5.801	5.204	0.012
Initial Honest x Initial Competent x Consistent Honest	0.701	1	0.701	0.284	0.298	1.216	1	1.216	0.927	0.169	0.358	1	0.358	0.160	0.345	0.409	1	0.409	0.304	0.291	0.079	1	0.079	0.071	0.396
Initial Honest x Initial Competent x Consistent Competent	0.259	1	0.259	0.105	0.374	0.217	1	0.217	0.165	0.343	1.630	1	1.630	0.728	0.198	0.522	1	0.522	0.388	0.267	0.100	1	0.100	0.090	0.388
Error	462.025	187	2.471			245.402	187	1.312			418.834	187	2.240			251.671	187	1.346			208.467	187	1.115		

[a]*Levene's test for equality of variances p=0.896* [b]*Levene's test for equality of variances p=0.115* [c]*Levene's test for equality of variances p=0.406* [d]*Levene's test for equality of variances p=0.865*
[e]*Levene's test for equality of variances p=0.627* **p-values are for one-tail test*

Variables:

Initial Honest = 1 if the behaviour of the financial controller is initially described as honest; 0 if not honest. Initial Competent = 1 if the behaviour of the financial controller is initially described as competent; 0 if not competent. Consistent = 1 if the second set of information about the financial controller is consistent with the initial behaviour; 0 if the second set of information about financial controller is inconsistent with initial behaviour. Assertion = Difference between the auditors' first and second assessments of the audit assertions (1 – "Strongly believe that the assertion is NOT true", and 7 – "Strongly believe that the assertion is true").

Table 6.11
Significant Post Hoc Tests for the Differences between Auditors' Initial and Second Assessments (Games-Howell test)

(I)	(J)	Mean Difference (I-J)	Std. Error	Sig.*
Panel A: Cut-off Assertion				
Initial H&C and subsequent NH&C	Initial H&C and subsequent NH&NC	1.264	0.394	0.059
Initial H&NC and subsequent H&C	Initial H&C and subsequent NH&NC	1.856	0.475	0.010
Initial H&NC and subsequent NH&C	Initial H&C and subsequent NH&NC	1.532	0.490	0.061
Initial H&NC and subsequent NH&NC	Initial H&C and subsequent NH&NC	1.507	0.418	0.023
Initial NH&C and subsequent H&C	Initial H&C and subssequent NH&NC	1.810	0.445	0.007
Initial NH&C and subsequent H&C	Initial NH&C and subsequent H&NC	1.127	0.381	0.084
Initial NH&NC and subsequent H&C	Initial H&C and subsequent NH&NC	1.460	0.412	0.028
Initial NH&NC and subsequent H&NC	Initial H&C and subsequent NH&NC	1.624	0.441	0.018
Panel B: Accuracy Assertion				
Initial H&C and subsequent NH&C	Initial NH&C and subsequent H&NC	-1.504	0.501	0.081

* *p-values are for one tail tests.*

H&C is where the financial controller is described as honest and competent. H&NC is where the financial controller is described as honest and not competent. NH&C is where the financial controller is described as not honest and competent. NH&NC is where the financial controller is described as not honest and not compete

Both the MANOVA and ANOVA results show that Initial Honest does not have a significant main effect on the differences between the auditors' initial and second assessments. Therefore the initial description about the honesty of the financial controller does not affect auditors' revisions to their initial assessments.

The MANOVA results show that Initial Competent has a significant main effect (p-value = 0.057), but the ANOVA results indicate that Initial Competent has a significant main effect only for the cut-off assertion (p-value = 0.017). There is no significant main effect for the completeness, accuracy, overall cash transaction, and overall cash and cash balance assertions (p-values = 0.183, 0.486, 0.430 and 0.115 respectively).

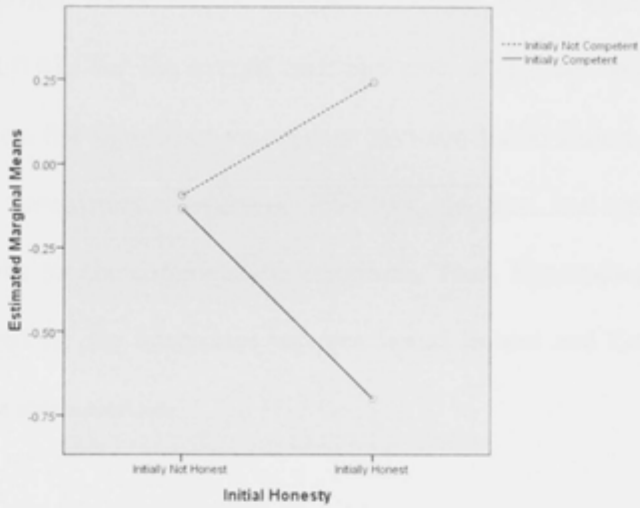
Hypothesis 2a predicts that auditors' revisions to their initial assessments are greater when management is initially described as not honest or not competent and subsequent information also indicates that they are not honest or not competent compared to when they are initially described as honest or competent and subsequent information also indicates that they are honest or competent. Consistent Honest has a significant main effect on auditors' assessment revisions, where the MANOVA p-value is 0.036. However, the ANOVA results are mixed. It has a significant main effect for the cut-off assertion (p-value = 0.096) and the accuracy assertion (p-value = 0.042) but is not significant for the completeness, overall cash transaction, and overall cash and cash equivalent balance assertions (p-values are 0.277, 0.154 and 0.316 respectively). The MANOVA results show a significant p-value of 0.000 for Consistent Competent. The ANOVA results show that it is significant for the cut-off (p-value = 0.001) and accuracy (p-value = 0.022) assertions but is not significant for the completeness (p-value = 0.334), overall cash transaction (p-value = 0.287), and overall cash and cash equivalent balance assertion (p-value = 0.386).

Although there are significant main effects for Consistent Honest and Consistent Competent, the revisions are not always in the right direction. For the cut-off assertion, Table 6.8 shows that the revisions are negative when the financial controller is consistently described as honest and consistently described as not honest, but the revisions are larger and negative for the consistent descriptions as honest. For the accuracy assertion, the auditors actually increase their assessments when the financial controller is consistently described as not honest. Therefore, H2a is not supported for consistent honest (not honest) descriptions of the financial controller.

For Consistent Competent (Not Competent) for the cut-off assertion, the revisions are positive for consistent Competent and negative for Consistent Not Competent, which supports H2a for consistent competent (not competent) descriptions of the financial controller for the cut-off assertion. For the accuracy assertion, the auditors actually increased their assessments when the information consistently described the financial controller as not competent, which does not support H2a for consistent competent (not competent) descriptions of the financial controller.

The MANOVA results indicate a significant interaction effect between Initial Honest and Initial Competent (p-value = 0.023), but the ANOVA results show that this interaction is only significant for the cut-off assertion (p-value = 0.003) and the overall cash transaction assertion (p-value = 0.084). The p-values are 0.429, 0.384 and 0.434 for the completeness, accuracy and overall cash and cash equivalent balance assertions respectively. The significant interaction for the cut-off assertion is shown in Figure 6.2

Figure 6.2
The Interaction Effect between Initial Honesty and Initial Competency of the Financial Controller on the Differences between Auditors' Initial and Second Assessments of the Cut-off Assertion



The Games-Howell tests for the cut-off assertion indicate that the average assessment revisions are higher when the financial controller is initially described as honest and not competent compared to when he is initially described as honest and competent (p-values = 0.010, 0.061, 0.023 and 0.007). The average assessment revisions are also higher when the financial controller is initially described as not honest and not competent than when he is initially described as honest and competent (p-values = 0.028 and 0.018). Initially describing the financial controller as not honest and/or not competent may result in higher revisions to auditors' assessments. Therefore, H2b is supported for the interaction between Initial Honest and Initial Competent for the cut-off assertion.

The MANOVA results show there is a significant interaction between Initial Honest and Consistent Honest (p-value = 0.058). The ANOVA results are consistent with the MANOVA results. The p-values are 0.069 for the completeness assertion, 0.072 for the cut-off assertion, 0.019 for the accuracy assertion, 0.005 for the overall cash transaction and 0.012 for the overall cash and cash equivalent balance assertions. Figure 6.3 depicts the significant interactions between Initial Honest and Consistent Honest for the completeness assertion. However, the post hoc tests do not show significant results for the completeness assertions. Thus, Hypotheses 2b, 2c and 2d are not supported for the interaction between Initial Honest and Consistent Honest for the completeness assertion.

Figure 6.3
The Interaction Effect between Initial Honesty and Consistency of Honesty of the Financial Controller on the Differences between Auditors' Initial and Second Assessments of the Completeness Assertion

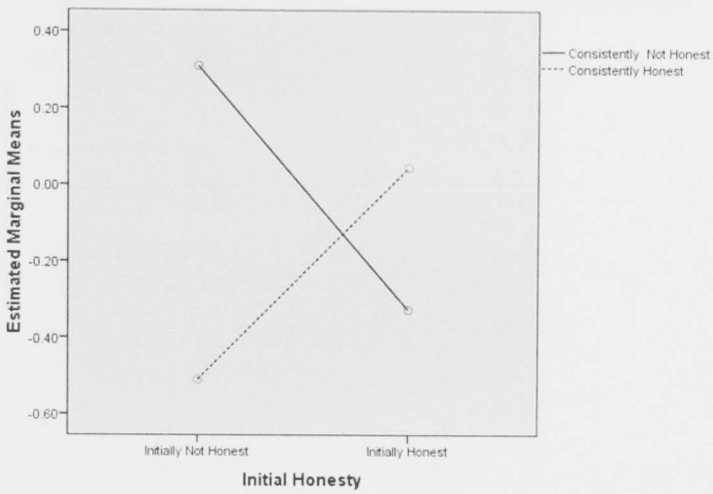
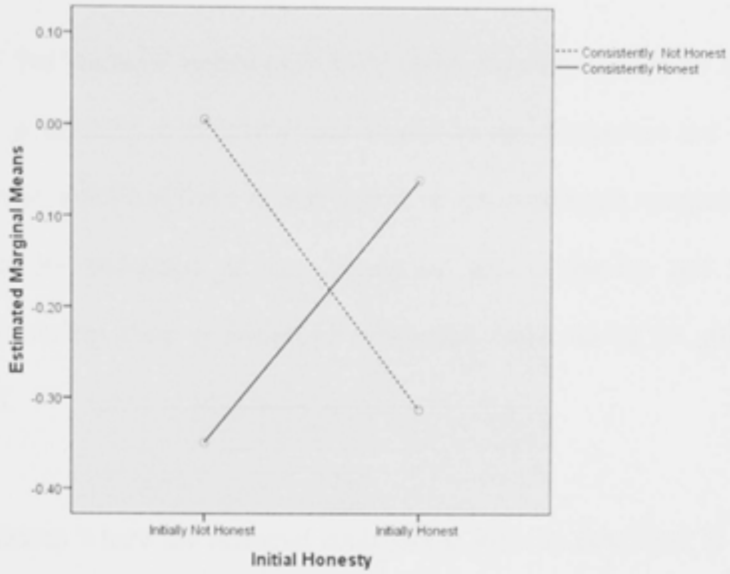


Figure 6.4 shows the significant interaction between the financial controller's initial honesty and his consistency of honesty for the cut-off assertion.

Figure 6.4
The Interaction Effect between Initial Honesty and Consistency of Honesty of the Financial Controller on the Differences between Auditors' Initial and Second Assessments of the Cut-off Assertion



H2b predicts that auditors' revisions to their initial assessments are greater when management is initially described as honest or competent and is subsequently described as not honest or not competent compared to when they are initially described as not honest or not competent and are subsequently described as honest or competent. Several of the post-hoc tests reported in Table 6.11 support H2b for the cut-off assertion.

H2c predicts that auditors' revisions to their initial assessments will be larger when management is initially portrayed as honest or competent and subsequent information describes them as not honest or not competent than when management is initially portrayed as honest or competent and subsequent information also indicates that they are honest or competent. None of the post-hoc tests reported in Table 6.11 support H2c.

H2d predicts that auditors' revisions to their initial assessments will be larger when management is initially described as not honest or not competent and subsequent information also describes them as not honest or not competent compared to when they are initially described as not honest or not competent and subsequent information describes them as honest or competent. Only one of the post-hoc tests supports H2d.

For the conditions where the financial controller is initially described as not honest and subsequently described as honest, the assessment revisions are significantly higher than when he is initially described as honest and subsequently as not honest (p-value = 0.007, 0.028 and 0.018). Initially describing the financial controller as not honest and subsequently describing him as still not honest does not necessarily result in higher revisions to auditors' average assessment revisions compared to when he is initially described as honest and subsequently described as still honest or not honest. Similarly, when the financial controller is not consistently described as honest (i.e., he is initially described as honest and subsequently described as not honest) does not necessarily result in larger average assessment revisions compared to when he is initially described as not honest or honest and is subsequently described as honest.

Figure 6.5
The Interaction Effect between Initial Honesty and Consistency of Honesty of the Financial Controller on the Differences between Auditors' Initial and Second Assessments of the Accuracy Assertion

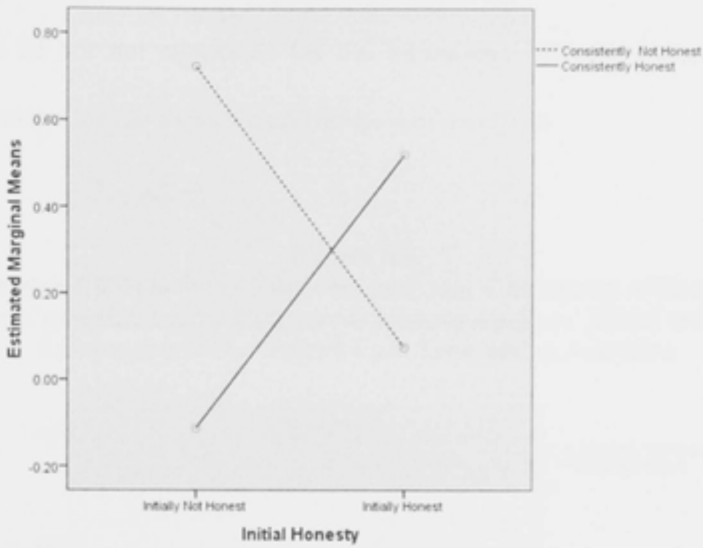


Figure 6.5 shows that there is a significant interaction between the financial controller's initial honesty and his consistency of honesty for the accuracy assertion. The post hoc tests indicate that the auditors' average assessment revisions are significantly lower when the financial controller is initially described as honest and consistently competent compared to when he is initially described as not honest and not consistently described as competent, i.e., he is initially described as competent and subsequently not competent (p-value = 0.081). Positive descriptions of the financial controller do not result in higher revisions to auditors' assessments. Therefore, H2b is not supported for the interaction between Initial Honest and Consistent Honest for the accuracy assertion.

Figure 6.6 depicts the significant interaction between the initial honesty and consistency of honesty of the financial controller for the overall cash transaction assertion. However, the post hoc tests do not show significant results and, therefore, H2b, 2c and 2d are not supported for the interaction between Initial Honest and Consistent Honest for the overall cash transaction assertion.

Figure 6.6
The Interaction Effect between Initial Honesty and Consistency of Honesty of the Financial Controller on the Differences between Auditors' Initial and Second Assessments of the Overall Cash Transaction Assertion

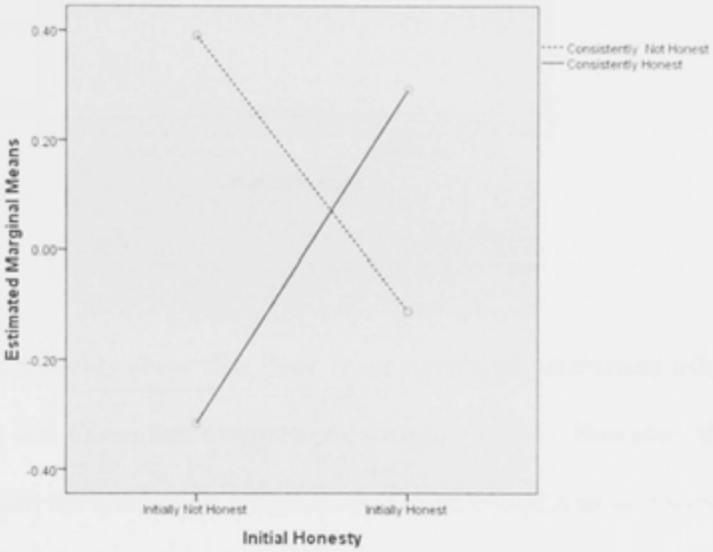
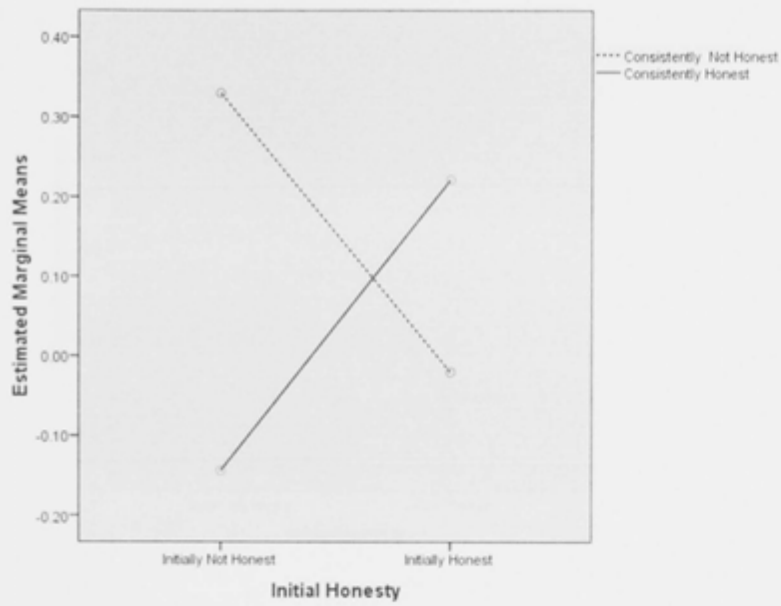


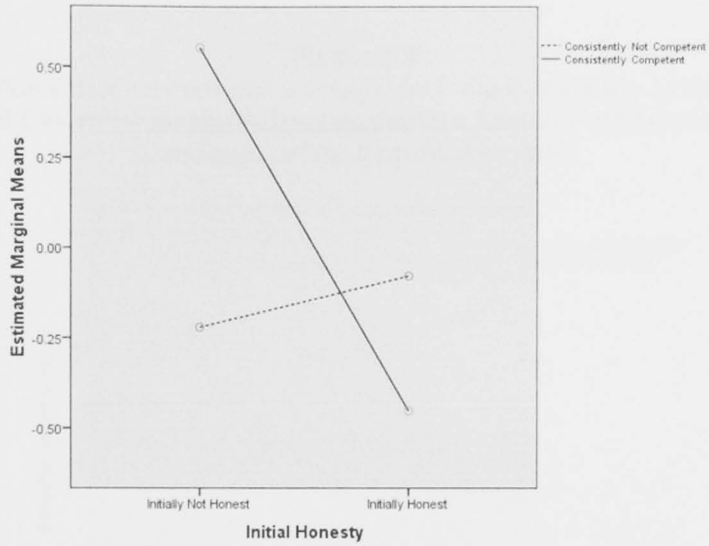
Figure 6.7 depicts the significant interaction between initial honesty and consistency of honesty of the financial controller for the overall cash and cash equivalent balance assertion. However, the post hoc tests do not show any significant results. Therefore, H2b, 2c and 2d are not supported for the interaction between Initial Honest and Consistent Honest.

Figure 6.7
The Interaction Effect between Initial Honesty and Consistency of Honesty of the Financial Controller on the Differences between Auditors' Initial and Second Assessments of the Overall Cash And Cash Equivalent Balance



The MANOVA results show that there is no significant interaction effect between Initial Honest and Consistent Competent (p-value = 0.291). However, the ANOVA results show that the interaction is significant for the completeness assertion (p-value = 0.091). The interaction is not significant for the other assertions (p-values = 0.474 for the cut-off assertion, 0.247 for the accuracy assertion, 0.442 assertion for the overall cash transaction assertion, and 0.243 for the overall cash and cash equivalent balance). The significant interaction between initial honesty and consistency of competency of the financial controller for the completeness assertion is shown in Figure 6.8.

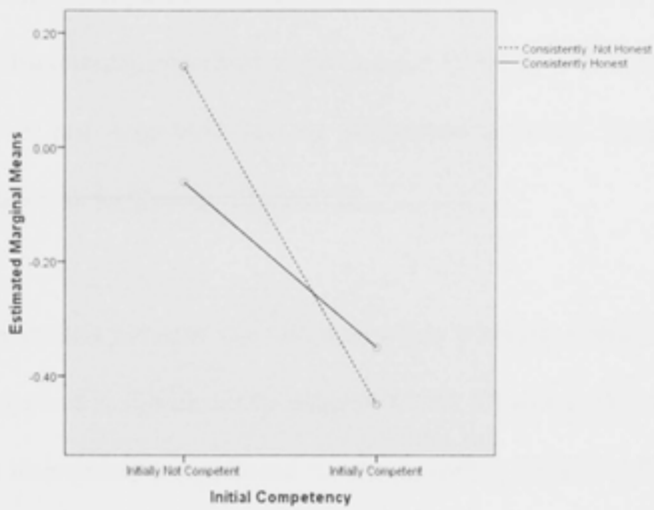
Figure 6.8
The Interaction Effect between Initial Honesty and Consistency of Competency of the Financial Controller for the Differences between Auditors' Initial and Second Assessments of the Completeness Assertion



However, the Games-Howell tests do not show any significant differences in the comparisons of the conditions for the completeness assertion. Therefore, H2b, 2c and 2d are not supported for the interaction between Initial Honest and Consistent Competent for the completeness assertion.

The MANOVA results show a significant interaction effect between Initial Competent and Consistent Honest (p-value = 0.084). However, the ANOVA results show that the interaction is significant only for the cut-off assertion (p-value = 0.017). The interaction is not significant for the other assertions, where the p-values are 0.419 for the completeness assertion, 0.486 for the accuracy assertion, 0.278 for the overall cash transaction, and 0.268 for the overall cash and cash equivalent balance transaction. Figure 6.9 show the interaction effect between initial competency and consistency of honesty for the cut-off assertion.

Figure 6.9
The Interaction Effect between Initial Competency and Consistency of Honesty of the Financial Controller for the Differences between Auditors' Initial and Second Assessments of the Cut-off Assertion

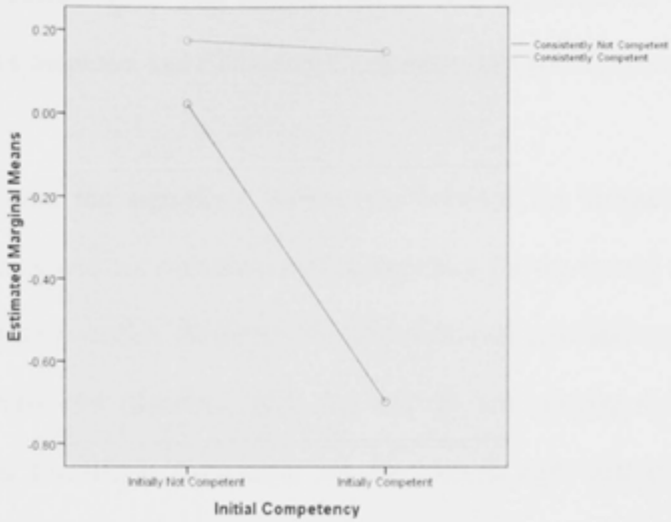


The Games-Howell post hoc tests indicate that the average assessment revisions are significantly higher when the financial controller is initially described as not competent and is not consistently described as honest (i.e., he is initially described as honest and subsequently described as not honest) compared to when he is initially described as competent and is not consistently described as honest (p-value = 0.061 and 0.023). Initially describing the financial controller as competent or not competent may affect auditors' assessments particularly for the conditions where he is not consistently described as honest (i.e., he is initially described as honest and subsequently described as not honest). Therefore, H2b is supported for Initial Competent and Consistent Honest for the cut-off assertion.

However, the assessment revisions are significantly higher when the financial controller is initially described as competent and not honest but is subsequently described as honest compared to when he is initially described as competent and honest but is subsequently described as not honest (p-value = 0.007) for the cut-off assertion. H2c is not supported for the interaction between Initial Honest and Consistent Competent for the cut-off assertion.

The MANOVA results indicate that the interaction between Initial Competent and Consistent Competent is significant (p-value = 0.006). However, the ANOVA results are mixed. The interaction is significant for the cut-off (p-value = 0.003) and overall cash and cash equivalent balance assertion (p-value = 0.012). It is not significant for the completeness (p-value = 0.141), accuracy (p-value = 0.311) and overall cash transaction (p-value = 0.167) assertions. Figure 6.10 depicts the significant interaction between initial competency and consistency of competency of the financial controller for the cut-off assertion.

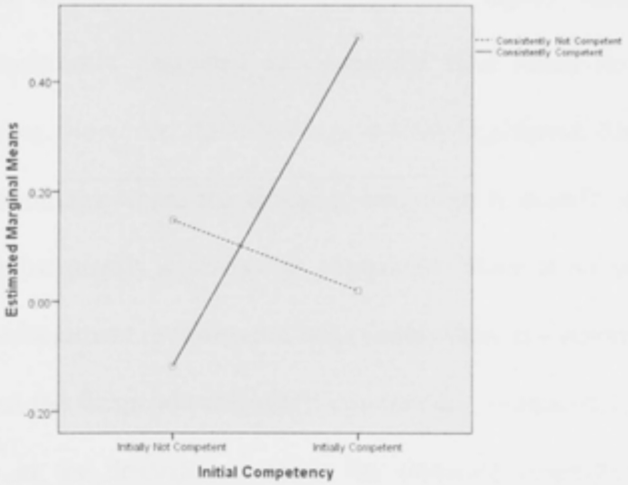
Figure 6.10
The Interaction Effect between Initial Competency and Consistency of Competency of the Financial Controller for the Differences between Auditors' Initial and Second Assessments of the Cut-off Assertion



The Games-Howell results for the cut-off assertion show that the auditors' assessment revisions are significantly higher when the financial controller is initially described as competent and is consistently described as competent compared to when he is initially described as competent and is not consistently competent (p-value = 0.059, 0.007 and 0.084). Therefore, H2c is not supported for Initial Competent and Consistent Competent. The average assessment revisions are also significantly higher for the conditions where the financial controller is initially described as not competent and is subsequently described as competent compared to the conditions where he is initially competent and subsequently described as not competent (p-values = 0.010, 0.061 and 0.028). Therefore, H2b is not supported for the interaction between Initial Competent and Consistent Competent. However, the average assessment revisions are significantly higher when the financial controller is initially described as not competent and is consistently described as not competent compared to when he is initially described as competent and is not consistently described as competent (p-values = 0.023 and 0.018). Thus, H2d is supported for the interaction between Initial Competent and Consistent Competent only for the cut-off assertion.

Figure 6.11 shows the significant interactions between the financial controller's initial competency and his consistency of competence for the overall cash and cash equivalent balance assertion. However, the Games-Howell post hoc tests do not show significant results and therefore, H2b, 2c and 2d are not supported for Initial Competent and Consistent Competent for the overall cash and cash equivalent balance assertion.

Figure 6.11
The Interaction Effect between Initial Competency and Consistency of Competency of the Financial Controller for the Differences between Auditors' Initial and Second Assessments of the Overall Cash and Cash Equivalent Balance Assertion



The three-way interactions between Initial Honest, Initial Competent and Consistent Honest show insignificant results for both the MANOVA (p-value = 0.298) and the ANOVAs for all the assertions, where the p-values are 0.298, 0.169, 0.345, 0.291 and 0.396 respectively for the completeness, cut-off, accuracy, overall cash transaction, and overall cash and cash equivalent balance assertions.

There is also no significant interaction between Initial Honest, Initial Competent, and Consistent Competent for both the MANOVA (p-value = 0.367) and the ANOVAs (p-values are 0.374, 0.343, 0.198, 0.267 and 0.388 respectively for the completeness, cut-off, accuracy, overall cash transaction, and overall cash and cash equivalent balance assertions).

The Games-Howell post hoc tests do not indicate any significant results for any of the conditions to indicate a positivity bias or a negativity bias. Some of the results indicate that the average assessment revisions are higher when the financial controller is consistently described as competent than when he is consistently described as honest. However, these findings are not significant. Similar results are found for the conditions where the financial controller is initially described as not competent and subsequently described as competent. There is no evidence to show that the average assessment revisions are larger when there is a positive change in the descriptions about the financial controller's competency compared to when there is a positive change in the descriptions about the financial controller's competency. Therefore, H3a is not supported for the positivity bias.

Similarly, there are no significant findings to indicate that the average assessment revisions of the audit assertions are larger when there is a negative change in the descriptions about the financial controller's honesty than when there is a negative change in the descriptions about the financial controller's competency. Thus, H3b is also not supported for the negativity bias.

6.5.2 Second Assessments

Table 6.12 shows the descriptive statistics for the auditors' second assessments after they read the additional information that either confirms or disconfirms the initial honesty and competency of financial controller. The figures in this table are based on the initial information about the financial controller's honesty and competency. Table 6.12 reports that, for each of the assertions, the average second assessment is higher when the financial controller is initially described as honest compared to when he is initially described as not honest. Similarly, as shown in the columns reporting descriptive statistics for Initial Competent and Initial Not Competent, the average second assessment is higher for each assertion when the financial controller is initially described as competent compared to when he is initially described as not competent, except for the cut-off assertion. For the cut-off assertion, the average second assessment is higher when the financial controller is initially described as not competent compared to when he is described as competent.

Table 6.12
Descriptive Statistics on Auditors' Second Assessments of Audit Assertions Based on Initial Information about the Honesty and Competency of the Financial Controller [mean (standard deviation)]

Behaviour	Initial Honest	Initial Not Honest	Initial Competent	Initial Not Competent
Assertion				
Completeness	2.804 (1.448) n = 97	2.618 (1.435) n = 102	2.829 (1.397) n = 105	2.575 (1.485) n = 94
Cut-off	2.412 (1.205) n = 97	2.265 (1.274) n = 102	2.133 (1.084) n = 105	2.564 (1.364) n = 94
Accuracy	2.495 (1.480) n = 97	2.422 (1.331) n = 102	2.648 (1.400) n = 105	2.245 (1.381) n = 94
Overall cash transactions	2.474 (1.331) n = 97	2.412 (1.367) n = 102	2.552 (1.293) n = 105	2.319 (1.401) n = 94
Overall cash and cash equivalent balances	2.443 (1.369) n = 97	2.373 (1.327) n = 102	2.562 (1.351) n = 105	2.234 (1.323) n = 94

Variables:
Initial Honest (Not Honest) = the initial description of the financial controller's behaviour indicates he is honest (not honest). Initial Competent (Not Competent) = the initial description of the financial controller's behaviour indicates he is competent (not competent). Assertion: Subjects' initial assessments of the audit assertion (1 – "Strongly believe that the assertion is NOT true", and 7 – "Strongly believe that the assertion is true").

Table 6.13 shows the descriptive statistics for the auditors' second assessments based on whether the financial controller is consistently described as honest or consistently described as competent. For each of the assertions, the average second assessment is lower when the financial controller is consistently described as honest compared to when he is consistently described as not honest. As shown in columns reporting descriptive statistics for Consistent Competent and Consistent Not Competent, the average second assessment is higher for each assertion when the financial controller is consistently described as competent compared to when he is consistently described as not competent, except for the accuracy assertion. For the accuracy assertion, the average second assessment is higher when the financial controller is consistently described as not competent compared to when he is consistently described as competent.

Table 6.13
Descriptive Statistics on Auditors' Second Assessments of Audit Assertions Based on Information about the Consistency of Honesty and Competency of the Financial Controller [mean (standard deviation)]

Behaviour	Consistent Honest	Consistent Not Honest	Consistent Competent	Consistent Not Competent	Not Consistent Honest	Not consistent Not Honest	Not Consistent Competent	Not Consistent Not Competent
Assertion								
Completeness	2.403 (1.303) n = 67	2.864 (1.487) n = 132	2.812 (1.517) n = 69	2.654 (1.402) n = 130	2.800 (1.492) n = 65	2.664 (1.419) n = 134	2.700 (1.301) n = 70	2.713 (1.517) n = 129
Cut-off	2.194 (1.294) n = 67	2.409 (1.210) n = 132	2.638 (1.260) n = 69	2.177 (1.204) n = 130	2.308 (1.089) n = 65	2.351 (1.311) n = 134	1.857 (0.952) n = 70	2.597 (1.302) n = 129
Accuracy	2.403 (1.371) N = 67	2.485 (1.422) N = 132	2.420 (1.509) N = 69	2.477 (1.348) n = 130	2.339 (1.417) n = 65	2.515 (1.397) n = 134	2.629 (1.287) n = 70	2.364 (1.457) n = 129
Overall cash transactions	2.313 (1.246) n = 67	2.508 (1.395) n = 132	2.478 (1.421) n = 69	2.423 (1.311) n = 130	2.339 (1.314) n = 65	2.493 (1.364) n = 134	2.371 (1.079) n = 70	2.481 (1.474 n = 129
Overall cash and cash equivalent balances	2.299 (1.279) n = 67	2.462 (1.378) n = 132	2.507 (1.481) n = 69	2.354 (1.269) n = 130	2.369 (1.431) n = 65	2.425 (1.306) n = 134	2.343 (1.128) n = 70	2.442 (1.452) n = 129

Variables:
Consistent Honest (Not Honest) indicates both the initial and second descriptions of the financial controller indicate he is honest (not honest). Consistent Competent indicates both the initial and second descriptions of the financial controller indicate he is competent (not competent). Not Consistent Honest indicates the initial description of the financial controller indicates he is honest and the second description indicates he is not honest. Not Consistent Not Honest indicates the initial description of the financial controller indicates he is not honest and the second description indicates he is honest. Not Consistent Competent indicates the initial description of the financial controller indicates he is competent and the second description indicates he is not competent. Not Consistent Not Competent indicates the initial description of the financial controller indicates he is not competent and the second description indicates he is competent.

Table 6.14 shows the descriptive statistics for the auditors' second assessments also based on the additional information that either confirms or disconfirms the initial honesty and competency of the financial controller.

H1a predicts that auditors' assessments on the truth of an audit assertion are higher when the financial controller is honest than when they are not honest. For the conditions where the financial controller is initially described as competent and subsequently described as not competent, the assessments are higher when they are described as consistently honest (the means are 2.706 for the completeness assertion, 2.059 for the cut-off assertion, 2.882 for the accuracy assertion, 2.647 for the overall cash transaction assertion, and 2.529 for the overall cash and cash equivalent balance assertion) than when they are described as consistently not honest (the means are 2.278 for the completeness assertion, 1.722 for the cut-off assertion, 2.167 for the accuracy assertion, 2.000 for the overall cash transaction assertion, and 2.222 for the overall cash and cash equivalent balance assertion).

Table 6.14
Descriptive Statistics on Auditors' Second Assessments of Audit Assertions Based on Consistent or Inconsistent Information about the Honesty and Competency of the Financial Controller [mean (standard deviation)]

Initial Behaviour	Consistent Honesty and Inconsistent Competency	Inconsistent Honesty and Consistent Competency	Inconsistent Honesty and Inconsistent Competency
Panel A: Completeness Assertion			
Honest and Competent	2.706 (1.160) n = 17	2.938 (1.436) n = 16	3.000 (1.609) n = 18
Honest and Not Competent	2.933 (1.624) n = 15	2.353 (1.272) n = 17	2.929 (1.685) n = 14
Not Honest and Competent	2.278 (1.074) n = 18	3.211 (1.686) n = 19	2.824 (1.286) n = 17
Not Honest and Not Competent	1.765 (1.147) n = 17	2.706 (1.611) n = 17	2.929 (1.385) n = 14
Panel B: Cut-off Assertion			
Honest and Competent	2.059 (1.144) n = 17	2.563 (1.153) n = 16	1.889 (0.900) n = 18
Honest and Not Competent	3.267 (1.438) n = 15	2.471 (1.231) n = 17	2.357 (1.008) n = 14
Not Honest and Competent	1.722 (0.958) n = 18	2.790 (1.134) n = 19	1.765 (0.831) n = 17
Not Honest and Not Competent	1.882 (1.166) n = 17	2.706 (1.572) n = 17	2.786 (1.477) n = 14
Panel C: Accuracy Assertion			
Honest and Competent	2.882 (1.317) n = 17	2.688 (1.815) n = 16	2.611 (1.420) n = 18
Honest and Not Competent	2.733 (1.870) n = 15	1.882 (1.054) n = 17	2.143 (1.231) n = 14
Not Honest and Competent	2.167 (1.043) n = 18	2.684 (1.493) n = 19	2.882 (1.317) n = 17
Not Honest and Not Competent	1.882 (1.054) n = 17	2.412 (1.583) n = 17	2.500 (1.345) n = 14

Table 6.14 (continued)

Initial Behaviour	Consistent Honest and Inconsistent Competent	Inconsistent Honest and Consistent Competent	Inconsistent Honest and Inconsistent Competent
Panel D: Overall Cash Transaction Assertion			
Honest and Competent	2.647 (1.222) n = 17	2.750 (1.653) n = 16	2.278 (1.179) n = 18
Honest and Not Competent	2.867 (1.506) n = 15	1.882 (0.857) n = 17	2.500 (1.454) n = 14
Not Honest and Competent	2.000 (0.9070 n = 18	3.053 (1.580) n = 19	2.588 (0.939) n = 17
Not Honest and Not Competent	1.824 (1.131) n = 17	2.176 (1.237) n = 17	2.857 (1.956) n = 14
Panel E: Overall Cash and Cash Equivalent Balance Assertion			
Honest and Competent	2.529 (1.179) n = 17	3.063 (1.982) n = 16	2.278 (1.127) n = 18
Honest and Not Competent	2.667 (1.345) n = 15	1.765 (0.903) n = 17	2.429 (1.342) n = 14
Not Honest and Competent	2.222 (1.215) n = 18	2.947 (1.353) n = 19	2.353 (1.057) n = 17
Not Honest and Not Competent	1.824 (1.334) n = 17	2.235 (1.251) n = 17	2.643 (1.646) n = 14

Assertion: Subjects' second assessments of the assertions (1 – "Strongly believe that the assertion is NOT true", and 7 – "Strongly believe that the assertion is true").

Similarly, for the conditions where the financial controller is initially described as not competent and subsequently described as competent, the assessments are higher when he is described as consistently honest (means = 2.933, 3.267, 2.733, 2.867 and 2.667 respectively for the completeness, cut-off, accuracy, overall cash transaction, and overall cash and cash equivalent balance assertions) than when he is consistently described as not honest (means = 1.765, 1.882, 1.882, 1.824, and 1.824 respectively for the completeness, cut-off, accuracy, overall cash transaction, and overall cash and cash equivalent balance assertions).

For the conditions where the financial controller is initially described as not competent and subsequently described as competent, the average assessments are higher when the financial controller is initially described as not honest and subsequently described as honest (means = 2.786, 2.500, 2.857 and 2.643 respectively for the cut-off, accuracy, overall cash transaction, and overall cash and cash equivalent balance assertions) than when the financial controller is initially described as honest and subsequently described as not honest (means = 2.357, 2.143, 2.500 and 2.429 respectively for the cut-off, accuracy, overall cash transaction, and overall cash and cash equivalent balance assertions). However, the means are equal for the completeness assertion when the financial controller is initially described as not honest and subsequently described as honest; and when he is initially described as honest and subsequently described as not honest (mean = 2.929).

The results are mixed for the conditions where the financial controller is consistently described as competent. The assessments are higher when the financial controller is initially described as not honest and subsequently described as honest for the completeness, cut-off, overall cash transaction assertions (means = 3.211, 2.790 and 3.053 respectively) than when he is initially described as honest and subsequently described as not honest (means = 2.938, 2.563 and 2.750 respectively). However, the means are lower when the financial controller is initially described as not honest and subsequently described as honest for the accuracy, and overall cash and overall cash equivalent balance assertions (means = 2.684 and 2.947 respectively); and when he is initially described as honest and subsequently described as not honest (means = 2.688 and 3.063 respectively).

The results are also mixed for the conditions where the financial controller is initially described as competent and subsequently described as not competent. For the accuracy, overall cash transaction, and overall cash and cash equivalent balance assertions, the assessments are higher when he is initially described as not honest and subsequently described as honest (means = 2.882, 2.588 and 2.353) than when he is initially described as honest and subsequently described as not honest (means = 2.611, 2.278 and 2.278). For the completeness and cut-off assertions, the assessments are lower when the financial controller is initially described as not honest and subsequently described as honest (means = 2.824 and 1.765 respectively) than when he is initially described as honest and subsequently described as not honest (means = 3.000 and 1.889 respectively).

For the conditions where the financial controller is consistently described as not competent, the assessments are higher for all the assertions (means = 2.706, 2.706, 2.412, 2.176 and 2.235 respectively for the completeness, cut-off, accuracy, overall cash transaction, and overall cash and cash equivalent balance assertions) when he is initially described as not honest and subsequently described as honest than when he is initially described as honest and subsequently described as not honest (means = 2.353, 2.471, 1.882, 1.882, and 1.765 respectively for the completeness, cut-off, accuracy, overall cash transaction, and overall cash and cash equivalent balance assertions).

With regard to the competency of the financial controller, for the conditions where the financial controller is initially described as honest and subsequently described as not honest, consistently being described as competent results in higher assessments (means = 2.938, 2.563, 2.688, 2.750 and 3.063 respectively for the completeness, cut-off, accuracy, overall cash transaction, and overall cash and cash equivalent balance assertions) than when the financial controller is consistently described as not competent (means = 2.353, 2.471, 1.882, 1.882 and 1.765 respectively for the completeness, cut-off, accuracy, overall cash transaction, and overall cash and cash equivalent balance assertions). Similarly, for the conditions where the financial controller is initially described as not honest and subsequently described as honest, auditors' assessments are higher when he is consistently described as competent (means = 3.211, 2.790, 2.684, 3.053 and 2.947 respectively for the completeness, cut-off, accuracy, overall cash transaction, and overall cash and cash equivalent balance assertions) than when he is consistently described as not competent (means = 2.706, 2.706, 2.412, 2.176 and 2.235 respectively for the completeness, cut-off, accuracy, overall cash transaction, and overall cash and cash equivalent balance assertions).

However, different results are found for the conditions where the financial controller is consistently described as not honest. For these conditions, auditors' assessments are lower when the financial controller is initially described as not competent and subsequently described as competent (means = 1.765, 1.882, 1.882, 1.824 and 1.824 respectively for the completeness, cut-off, accuracy, overall cash transaction, and overall cash and cash equivalent balance assertions) than when he is initially described as competent and subsequently described as not competent (means = 2.278, 1.772, 2.167, 2.000 and 2.222 respectively for the completeness, cut-off, accuracy, overall cash transaction, and overall cash and cash equivalent balance assertions).

The results are mixed for the conditions where the financial controller is consistently described as honest. For the completeness, cut-off, overall cash transaction, and overall cash and cash equivalent balance assertions, the assessments are higher when he is initially described as not competent and subsequently described as competent (means = 2.933, 3.267, 2.867 and 2.667 respectively) than when he is initially described as competent and subsequently described as not competent (means = 2.706, 2.059, 2.647 and 2.529 respectively). The assessment is lower for the accuracy assertion when the financial controller is initially described as not competent and subsequently described as competent (mean = 2.733) than when he is initially described as competent and subsequently described as not competent (mean = 2.882).

For the conditions where the financial controller is initially described as honest and subsequently described as not honest, the assessment is higher when he is initially described as not competent and subsequently described as competent (means = 2.357, 2.500 and 2.429 respectively for the cut-off, overall cash transaction, and overall cash and cash equivalent balance assertions) than when he is initially described as competent and subsequently described as not competent (means = 1.889, 2.278 and 2.278 respectively for the cut-off, overall cash transaction, and overall cash and cash equivalent balance assertions). For the other two assertions, the assessments are lower when the financial controller is initially described as not competent and subsequently described as competent (means = 2.929 and 2.143 respectively for the completeness and accuracy assertions) than when he is initially described as competent and subsequently described as not competent (means = 3.000 and 2.611 respectively for the completeness and accuracy assertions).

Similarly, for the conditions where the financial controller is initially described as not honest and subsequently described as honest, the assessments are higher when he is initially described as not competent and subsequently described as competent for the completeness, cut-off overall cash transaction, and overall cash and cash equivalent balance assertions (means = 2.929, 2.786, 2.857 and 2.643 respectively) than when he is initially described as competent and subsequently described as not competent (means = 2.824, 1.765 2.588 and 2.353 respectively). For the accuracy assertion, auditors' assessments are lower when the financial controller is initially described as not competent and subsequently described as competent (mean = 2.500) than when he is initially described as competent and subsequently described as not competent (mean = 2.882).

The MANOVA and ANOVA results are shown in Tables 6.15 and 6.16. The MANOVA results show that the main effect for Initial Honest is not significant (p-value = 0.318) and the ANOVA results also show that it has no significant main effect for all the assertions. The p-values are 0.157 for completeness assertion, 0.101 for cut-off assertion, 0.240 for accuracy assertion, 0.217 for the overall cash transaction assertion and 0.253 for the overall cash and cash equivalent balance assertion. Thus, Hypothesis 1a is not supported for Initial Honest for all the assertions. The average second assessments are not necessarily higher when the financial controller is initially described as honest compared to when he is initially described as not honest.

Table 6.15
MANOVA Results for Auditors' Second Assessments of Audit Assertions

	Pillai's Trace	F	Hypothesis df	Error df	p-value*
Initial Honest	0.009	0.570	3	185	0.318
Initial Competent	0.112	7.792	3	185	0.000
Consistent Honest	0.037	2.379	3	185	0.036
Consistent Competent	0.055	3.590	3	185	0.008
Initial Honest x Initial Competent	0.012	0.721	3	185	0.270
Initial Honest x Consistent Honest	0.038	2.433	3	185	0.033
Initial Honest x Consistent Competent	0.006	0.395	3	185	0.379
Initial Competent x Consistent Honest	0.004	0.231	3	185	0.437
Initial Competent x Consistent Competent	0.027	1.726	3	185	0.082
Initial Honest x Initial Competent x Consistent Honest	0.025	1.549	3	185	0.102
Initial Honest x Initial Competent x Consistent Competent	0.007	0.461	3	185	0.355

Box's test of equality of covariance matrices p=0.000
**p-values are for one-tail test*
Variables:
Initial Honest = 1 if the behaviour of the financial controller is initially described as honest; 0 if not honest. Initial Competent = 1 if the behaviour of the financial controller is initially described as competent; 0 if not competent. Consistent = 1 if the second set of information about the financial controller is consistent with the initial behaviour; 0 if the second set of information about financial controller is inconsistent with initial behaviour. Assertion = Subjects' second assessments of the assertions (1 – "Strongly believe that the assertion is NOT true", and 7 – "Strongly believe that the assertion is true").

Table 6.16
ANOVA Results for Auditors' Second Assessments of Audit Assertions

	Completeness Assertion[a]					Cut-off Assertion[b]					Accuracy Assertion[c]					Overall cash Transaction Assertion[d]					Overall cash and Cash Equivalent Balance Assertion[e]				
	SS	df	Mean Square	F	Sig.*	SS	df	Mean Square	F	Sig.*	SS	df	Mean Square	F	Sig.*	SS	df	Mean Square	F	Sig.*	SS	df	Mean Square	F	Sig.*
Initial Honest	2.089	1	2.089	1.025	0.157	2.280	1	2.280	1.637	0.101	0.983	1	0.983	0.503	0.240	1.075	1	1.075	0.614	0.217	0.787	1	0.787	0.447	0.253
Initial Competent	3.435	1	3.435	1.686	0.098	6.988	1	6.988	5.016	0.013	6.982	1	0.982	3.571	0.030	3.943	1	3.943	2.254	0.068	7.834	1	7.834	4.449	0.018
Consistent Honest	8.038	1	8.038	3.946	0.024	0.036	1	0.036	0.026	0.437	0.447	1	0.447	0.229	0.317	1.579	1	1.579	0.902	0.177	0.426	1	0.426	0.242	0.317
Consistent Competent	0.458	1	0.458	0.225	0.318	6.122	1	6.122	4.394	0.019	0.452	1	0.452	0.231	0.316	0.267	1	0.267	0.153	0.349	0.193	1	0.193	0.110	0.371
Interactions																									
Initial Honest x Initial Competent	0.610	1	0.610	0.299	0.293	1.084	1	1.084	0.778	0.190	0.361	1	0.361	0.185	0.334	0.271	1	0.271	0.155	0.348	0.027	1	0.127	0.015	0.451
Initial Honest x Consistent Honest	4.058	1	4.058	1.992	0.080	8.251	1	8.251	5.923	0.008	9.693	1	9.693	4.957	0.014	11.183	1	11.183	6.391	0.006	4.170	1	4.170	2.368	0.063
Initial Honest x Consistent Competent	1.314	1	1.314	0.645	0.212	0.051	1	0.051	0.037	0.425	0.021	1	0.021	0.011	0.459	0.010	1	0.010	0.006	0.470	0.009	1	0.009	0.005	0.472
Initial Competent x Consistent Honest	0.205	1	0.205	0.101	0.376	0.030	1	0.030	0.021	0.442	0.350	1	0.350	0.179	0.337	0.404	1	0.404	0.231	0.316	0.992	1	0.992	0.563	0.227
Initial Competent x Consistent Competent	2.573	1	2.573	1.263	0.132	5.656	1	5.656	4.060	0.023	0.105	1	0.105	0.054	0.409	10.193	1	10.193	5.826	0.009	12.255	1	12.255	6.960	0.005
Initial Honest x Initial Competent x Consistent Honest	1.692	1	1.692	0.830	0.182	5.153	1	5.153	3.699	0.028	0.098	1	0.098	0.050	0.412	0.394	1	0.304	0.225	0.318	0.917	1	0.017	0.521	0.236
Initial Honest x Initial Competent x Consistent Competent	0.019	1	0.019	0.009	0.462	0.605	1	0.605	0.434	0.256	0.407	1	0.407	0.208	0.325	0.006	1	0.006	0.004	0.953	0.407	1	0.407	0.231	0.316
Error	380.968	187	2.037			260.518	187	1.393			365.645	187	1.955			327.212	187	1.750			329.289	187	1.761		

[a]Levene's test for equality of variances p=0.538 *[b]Levene's test for equality of variances p=0.307* *[c]Levene's test for equality of variances p=0.156* *[d]Levene's test for equality of variances p=0.082*
[e]Levene's test for equality of variances p=0.190 **p-values are for one-tail test*
Variables:
Initial Honest = 1 if the behaviour of the financial controller is initially described as honest; 0 if not honest. Initial Competent = 1 if the behaviour of the financial controller is initially described as competent; 0 if not competent. Consistent = 1 if the second set of information about the financial controller is consistent with the initial behaviour; 0 if the second set of information about financial controller is inconsistent with initial behaviour. Assertion = Subjects' second assessments of the assertions (1 – "Strongly believe that the assertion is NOT true", and 7 – "Strongly believe that the assertion is true").

Initial Competent has a significant main effect on the auditors' assessments as shown in the MANOVA results (p-value = 0.000) and the ANOVA results are significant for all the assertions. The p-values are 0.098, 0.013, 0.030, 0.068 and 0.018 for the completeness, cut-off, accuracy, overall cash transaction, and overall cash and cash equivalent assertions respectively. Initially describing the financial controller as competent results in higher second assessments of the audit assertions compared to when he is initially described as not competent. Therefore, H1b is supported for Initial Competent for all the assertions.

The MANOVA results indicate that Consistent Honest has a significant main effect (p-value is 0.036). However, the ANOVA results are mixed, where the p-value is significant only for the completeness assertion (p-value = 0.024). It is not significant for the cut-off (p-value = 0.437), accuracy (p-value = 0.317), overall cash transaction (p-value = 0.177) and overall cash and cash equivalent balance (p-value = 0.317) assertions. However, consistently describing the financial controller as honest results in lower average second assessments compared to when he is consistently described as not honest. In addition, not consistently describing the financial controller as not honest results in higher second assessments compared to when he is consistently described as honest. Therefore, H1a is not supported for Consistent Honest.

Consistent Competent has a significant main effect. The MANOVA p-value is 0.008. However, the ANOVA results are mixed. Consistent competent has a significant main effect only for the cut-off assertion (p-value = 0.019) and is not significant for the completeness (p-value = 0.318), accuracy (p-value = 0.316), overall cash transaction (p-value = 0.349) and overall cash and cash equivalent balance (p-value = 0.371) assertions. Consistently describing the financial controller as competent results in higher second assessments compared to when he is consistently described as not competent. Similarly, not consistently describing him as not competent (i.e., he is initially described as not competent and subsequently described as competent) may result in higher second assessments compared to not consistently describing him as competent (i.e., he is initially described as competent and subsequently described as not competent). Therefore, H1b is supported for Consistent Competent, but only for the cut-off assertion.

The interaction between Initial Honest and Initial Competent is not significant. The p-value for MANOVA is 0.270 and the p-values for ANOVA are 0.293 for the completeness assertion, 0.190 for the cut-off assertion, 0.334 for the accuracy assertion, 0.348 for the overall cash transaction assertion and 0.451 for the overall cash and cash equivalent balance assertion. Thus, H1c is not supported for the interaction between Initial Honest and Initial Competent for all the assertions.

There is a significant interaction effect between Initial Honest and Consistent Honest. The MANOVA p-value is 0.033 and the ANOVA p-values are 0.080, 0.008, 0.014, 0.006 and 0.063 respectively for the completeness, cut-off, accuracy, overall cash transaction, and overall cash and cash equivalent balance assertions. Figure 6.12 shows this significant interaction for the completeness assertion.

Figure 6.12
The Interaction Effect between Initial Honesty and Competency of the Financial Contoller for Auditors' Second Assessments of the Completeness Assertion

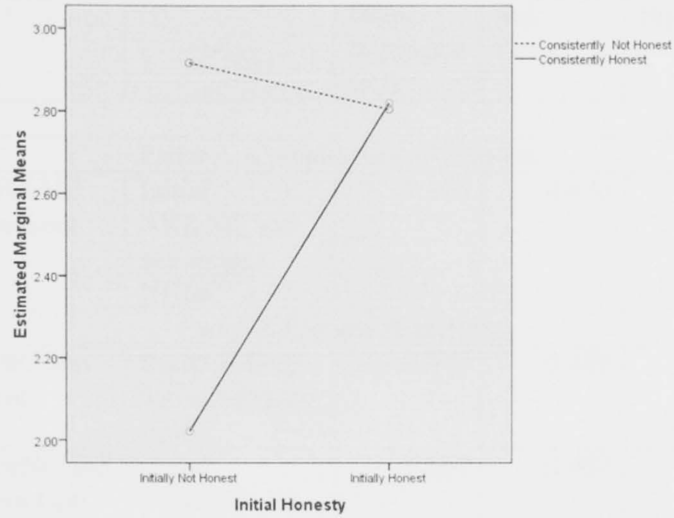


Table 6.17 shows the significant Games-Howell post hoc test results. Note that only the significant results are presented in Table 6.17.

Table 6.17
Significant Post Hoc Tests for Auditors' Second Assessments of Audit Assertions for the Interactions between the Descriptions of the Honesty and Competency of the Financial Controller (Games-Howell Test)

(I)	(J)	Mean difference (I-J)	Std. Error	Sig.*
Panel A: Completeness Assertion				
Initial NH&NC and subsequent H&C	Initial NH&NC and subsequent NH&C	1.446	0.476	0.073
Panel B: Cut-off Assertion				
Initial H&C and subsequent NH&NC	Initial H&NC and subsequent H&C	-1.378	0.428	0.057
Initial H&NC and subsequent H&C	Initial NH&NC and subsequent NH&C	1.384	0.467	0.087
Initial NH&C and subsequent H&NC	Initial H&NC and subsequent H&C	-1.502	0.422	0.030
Initial NH&C and subsequent H&NC	Initial NH&C and subsequent H&C	-1.025	0.329	0.061
Initial NH&C and subsequent NH&NC	Initial H&NC and subsequent H&C	-1.544	0.435	0.028
Initial NH&C and subsequent NH&NC	Initial NH&C and subsequent H&C	-1.067	0.345	0.062
Panel B: Overall Cash and Cash Equivalent Balance Assertion				
Initial H&NC and subsequent NH&NC	Initial NH&C and subsequent H&C	-1.183	0.380	0.062

* p-values are for one-tailed tests.
H&C is where the financial controller is described as honest and competent. H&NC is where the financial controller is described as honest and not competent. NH&C is where the financial controller is described as not honest and competent. NH&NC is where the financial controller is described as not honest and not competent.

The post hoc tests show that, for the completeness assertion, the auditors' second assessments are significantly higher when the financial controller is initially described as not honest and subsequently described as honest compared to when he is consistently described as not honest (p-value = 0.073). Thus, H1a is supported for the interaction between Initial Honest and Consistent Honest for the completeness assertion, where the second revisions are higher when the financial controller is initially described as honest and is also consistently described as honest compared to when he is initially described as not honest and is also consistently described as not honest.

Similar results are found for the cut-off assertion. Figure 6.13 depicts the significant interaction between Initial Honest and Consistent Honest for the cut-off assertion. The post hoc tests indicate that the auditors' average second assessments are significantly higher when the financial controller is consistently described as honest compared to when he is consistently described as not honest (p values = 0.087 and 0.028). When the financial controller is consistently described as not honest, the average second assessments are significantly lower than when he is initially described as not honest and subsequently as honest (p-value = 0.062). The average second assessments are significantly lower when the financial controller is initially described as honest and subsequently as not honest compared to when he is consistently described as honest (p-value = 0.057). Similarly, the average second assessments are significantly lower when the financial controller is initially described as not honest and subsequently as honest than when he is consistently described as honest (p-value = 0.030). Therefore, H1a is supported for the interaction between Initial Honest and Consistent Honest for the cut-off assertion.

Figure 6.13
The Interaction Effect between Initial Honesty and Consistency of Honesty of the Financial Controller for Auditors' Second Assessments of the Cut-off Assertion

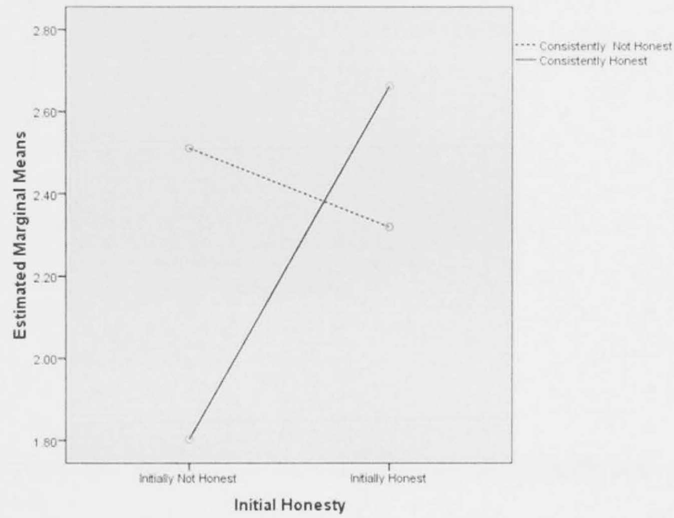


Figure 6.14 shows the significant interaction between initial honesty and consistency of honesty of the financial controller for the accuracy assertion. However, the post hoc tests do not show any significant results in the comparisons of the conditions. Therefore, H1a is not supported for the interaction between Initial Honest and Consistent Honest for the accuracy assertion.

Figure 6.14
The Interaction Effect between Initial Honesty and Consistency of Honesty of the Financial Controller for Auditor's Second Assessments of the Accuracy Assertion

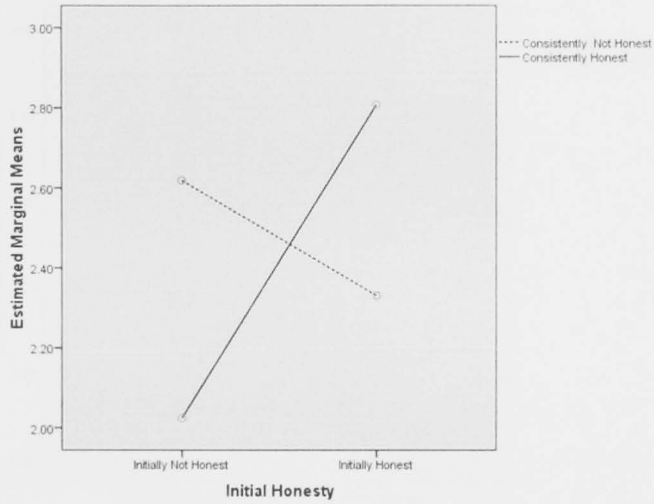


Figure 6.15 depicts the interaction between the initial honesty and consistency of honesty of the financial controller for the overall cash transaction assertion. However, the Games-Howell post hoc tests do not show any significant results when comparing the conditions. Therefore, H1a is not supported for the interaction between Initial Honest and Consistent Honest for the overall cash transaction assertion.

Figure 6.15
The Interaction Effect between Initial Honesty and Consistency of Honesty of the Financial Controller for Auditor's Second Assessments of the Overall Cash Transaction Assertion

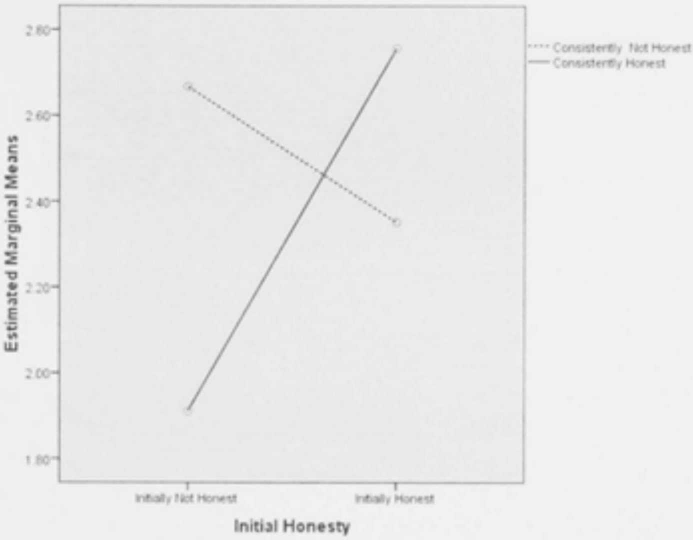
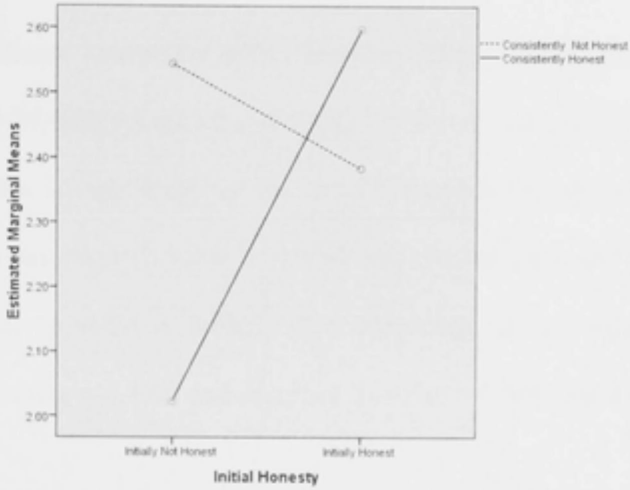


Figure 6.16 depicts the interaction between initial honesty and consistency of honesty of the financial controller for the overall cash and cash equivalent balance assertion. The post hoc tests show that the auditors' average second assessments are significantly lower when the financial controller is initially described as honest and subsequently as not honest compared to when he initially described as not honest and subsequently as honest (p-value = 0.062). Therefore, H1a is supported for Initial Honest and Consistent Honest for the overall cash and cash equivalent balance assertion.

Figure 6.16
The Interaction Effect between Initial Honesty and Consistency of Honesty of the Financial Controller for Auditors' Second Assessments of the Overall Cash and Cash Equivalent Balance Assertion



The MANOVA result for the interaction effect between Initial Honest and Consistent Competent is not significant (p-value = 0.379) and the ANOVA results are also not significant. The p-values are 0.212 for the completeness assertion, 0.425 for the cut-off assertion, 0.459 for the accuracy assertion, 0.470 for the overall cash transaction assertion and 0.472 for the overall cash and cash equivalent balance assertion. Therefore, H1c is not supported for the interaction between Initial Honest and Consistent Competent for all the assertions.

The interaction effect between Initial Competent and Consistent Honest is also not significant as the MANOVA p-value is 0.437. The ANOVA results also show that the interaction is not significant for all the assertions, where the p-values are 0.376, 0.442, 0.337, 0.316 and 0.227 respectively for the completeness, cut-off, accuracy, overall cash transaction, and overall cash and cash equivalent balance assertions.

Therefore, H1c is not supported for the interaction between Initial Competent and Consistent Honest.

There is a significant interaction effect between Initial Competent and Consistent Competent. The MANOVA p-value is 0.082. However, the ANOVA results show that the interaction is significant for the cut-off assertion (p-value = 0.023), overall cash transaction assertion (p-value = 0.009) and overall cash and cash equivalent balance assertion (p-value = 0.005). The interaction is not significant for the completeness (p-value = 0.132) and accuracy (p-value = 0.409) assertions.

Figure 6.17 depicts the interaction between initial competency and consistency of competency of the financial controller for the cut-off assertion. The Games-Howell post hoc tests indicate that the auditors' average second assessments are significantly lower when the financial controller is initially described as competent and subsequently as not competent compared to when he is initially described as not competent and subsequently as competent (p-values = 0.057, 0.030 and 0.028). The average second assessments are also significantly lower when the financial controller is initially described as competent and subsequently described as not competent than when he is consistently described as competent (p = values = 0.061 and 0.062). Therefore, H1b is supported for the interaction between Initial Honest and Initial Competent for the cut-off assertion.

Figure 6.17
The Interaction Effect between Initial Competency and Consistency of Competency of the Financial Controller for Auditors' Second Assessments of the Cut-off Assertion

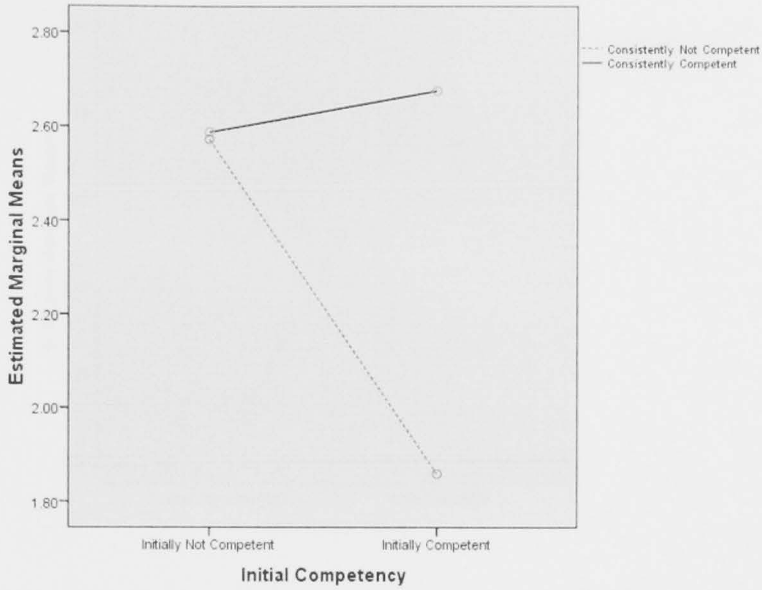


Figure 6.18 shows the interaction between initial competency and consistency of competency for the overall cash transaction. However, the post-hoc tests do not show any significant results. Therefore, H1b is not supported for the Initial Competent and Consistent Competent for the overall cash transaction assertion.

Figure 6.18
The Interaction Effect between Initial Competency and Consistency of Competency of the Financial Controller for Auditors' Assessments of the Overall Cash Transaction Assertion

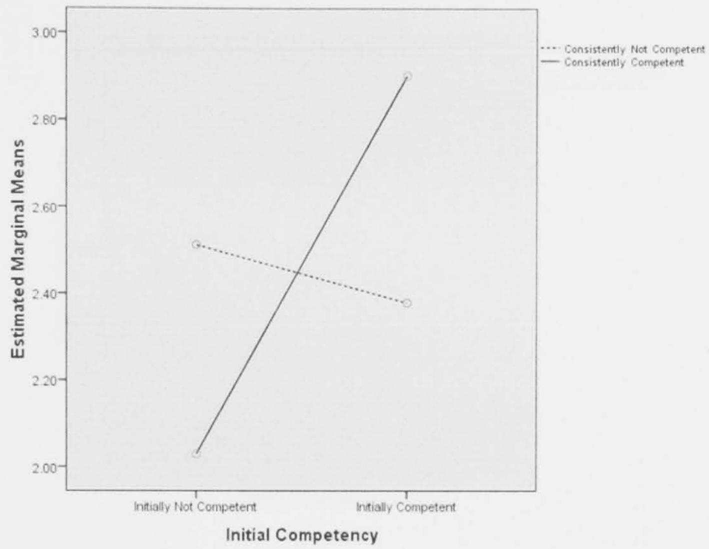
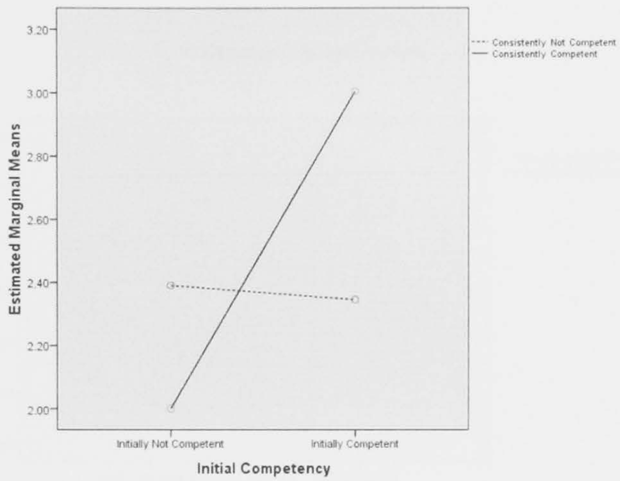


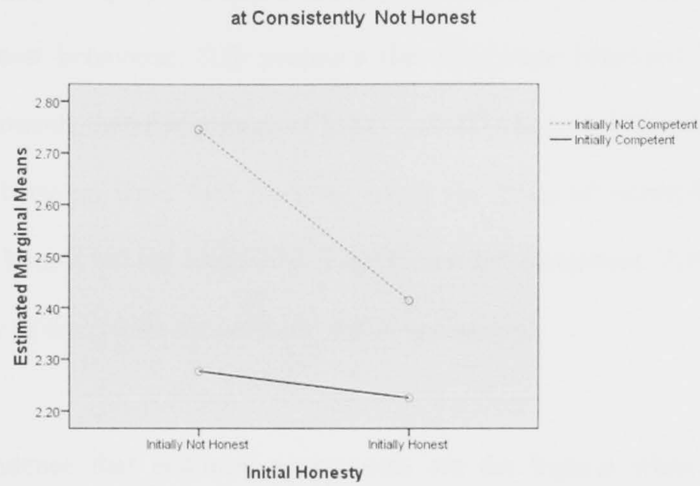
Figure 6.19 depicts the interaction between the initial competency and consistency of competency of the financial controller for the overall cash and cash equivalent balance assertion. The Games-Howell post hoc tests indicate that the auditors' average second assessments are significantly lower when the financial controller is consistently described as not competent compared to when he is consistently described as competent. Thus, H1b is supported for the initial Competent and Consistent Competent for the overall cash and cash equivalent balance assertion.

Figure 6.19
The Interaction Effect between Initial Competency and Consistency of Competency of the Financial Controller for Auditors' Second Assessments of the Cash and Cash Equivalent Balance Assertion



The three-way MANOVA result shows an insignificant interaction effect between Initial Honest, Initial Competent and Consistent Honest. However, the ANOVA results are mixed. The interaction effect is significant only for the cut-off assertion (p-value = 0.028) and is not significant for the completeness (p-value = 0.182), accuracy (p-value = 0.412), overall cash transaction (p-value = 0.318) and overall cash and cash equivalent balance (p-value = 0.236) assertions.

Figure 6.20
The Three-way Interaction Effect between Initial Honesty, Consistency of Competency and Consistency of Honesty for Auditors' Second Assessments of the Cut-off Assertion



The three-way MANOVA result shows an insignificant interaction effect between Initial Honest, Initial Competent and Consistent Competent. The ANOVA results also show insignificant p-values of 0.462 for the completeness assertion, 0.256 for the cut-off assertion, 0.325 for the accuracy, 0.953 for the overall cash transaction assertion and 0.316 for the overall cash and cash equivalent balance assertion.

6.6 Summary of the Results

In determining the effects of honesty and competency on auditors' judgments about audit assertions, H1a proposes that honest behaviour will result in higher assessments than not honest behaviour, H1b proposes that competent behaviour will result in higher assessments than not competent behaviour. H1c proposes that the assessments will fall in between these two extremes when the financial controller is initially described as honest but not competent or not honest but competent. Table 6.18 shows the summary of the results for auditors' initial assessments.

There is evidence that auditors' assessments are the highest when the financial controller is described as honest and competent; and their assessments are the lowest when the financial controller is described as not honest and not competent. This is true for all assertions except for the cut-off assertion. The results for the cut-off assertion show that the lowest assessment is found when the financial controller is described as not honest but competent.

Table 6.18
Summary of the Results for Auditors' Initial Assessments Based on the Initial Honesty and Competency of the Financial Controller

Assertion	Initial Honest (H1a)	Initial Competent (H1b)	Initial Honest x Initial Competent (H1c)
Completeness	Supported	Supported	Not Supported
Cut-off	Supported	Not Supported	Supported
Accuracy	Supported	Supported	Not Supported
Overall cash transaction	Not Supported	Supported	Not Supported
Overall cash and cash equivalent balance	Not Supported	Not Supported	Not Supported

H1a is supported for Initial Honest for the completeness, cut-off and accuracy assertions. The financial controller's honesty does not have a significant effect on the auditors' assessments of the overall audit assertions. H1b is supported for Initial Competent for the completeness, accuracy and overall cash transaction assertions. A significant interaction between Initial Honest and Initial Competent is found only for the cut-off assertion. Thus, H1c is supported, but only for the cut-off assertion. This interaction may explain why the lowest initial assessments are found in the conditions where the financial controller is initially described as not honest and competent and not in the conditions where he is initially described as both honest and competent. Auditors might be more sceptical when the financial controller is not honest but competent because a financial controller who is not honest may be prone to committing fraud and, being competent, is able to conceal the fraud.

Table 6.19 presents the summary of the results for the auditors' second assessments. Initial honesty of the financial controller has no significant effect on auditors' second assessments. Auditors do not seem to consider the change in the description of the honesty of the financial controller when they revise their initial assessments after reading the additional information about the change. However, initial competency of the financial controller affects the auditors' second assessments for all the audit assertions. These findings indicate that auditors seem to place more weight on the competency of the financial controller rather than his honesty.

Consistency of honesty has no significant effect on auditors' second assessments for all the assertions. When management is being consistently described as honest does not necessarily result in higher second assessments than them being described as consistently not honest. This is consistent with the results for initial description on management's honesty. These findings indicate that auditors do not seem to consider honesty in their assessments of audit assertions. However, consistency of honesty has significant effect on auditors' assessments, but only for the cut-off assertion.

The interaction between Initial Honest and Initial Competent does not have a significant effect on auditors' second assessments. However, describing the financial controller as initially and consistently honest, or describing him as initially and consistently not honest significantly affects the auditors' second assessments for three of the assertions, namely the completeness, cut-off and overall cash and cash equivalent balance assertions. Initial description of the financial controller's honesty does not affect auditors' second assessments; however, the additional information about his honesty affects auditors' second assessments. These findings indicate that auditors revise their initial assessments downward when the additional information indicates that the financial controller is not honest. In other words, auditors place more reliance on consistently honest management and are more likely to assess these audit assertions to be true when the management is consistently honest. On the other hand, less reliance may be placed on management who are consistently not honest or who may seem to be initially honest and later is found to be not honest.

Initial Honest and Consistent Competent do not have significant interaction effect on auditors' second assessments for all the audit assertions. Similarly, the interaction between Initial Competent and Consistent Honest also do not significantly affect the auditors' second assessments.

Table 6.19
Summary of the Results for Auditors' Second Assessments Based on the Revised Information about the Honesty and Competency of the Financial controller

Assertion	Initial Honest (H1a)	Initial Competent (H1b)	Consistent Honest (H1a)	Consistent Competent (Hb)	Initial Honest x Initial Competent (H1c)	Initial Honest x Consistent Honest (H1a)	Initial Honest x Consistent Competent (H1c)	Initial Competent x Consistent Honest (H1c)	Initial Competent x Consistent Competent (H1b)	Initial Honest x Initial Competent x Consistent Honest (H1c)	Initial Honest x Initial Competent x Consistent Competent (H1c)
Completeness	Not Supp	Supported	Not Supp	Not Supp	Not Supp	Supported	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp
Cut-off	Not Supp	Supported	Not Supp	Supported	Not Supp	Supported	Not Supp	Not Supp	Supported	Not Supp	Not Supp
Accuracy	Not Supp	Supported	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp
Overall Cash Transaction	Not Supp	Supported	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp
Overall Cash and Cash Equivalent Balance	Not Supp	Supported	Not Supp	Not Supp	Not Supp	Supported	Not Supp	Not Supp	Supported	Not Supp	Not Supp

Initial Competent and Consistent Competent have a significant interaction effect on the auditors' second assessments for the cut-off and overall cash and cash equivalent balance assertions. Auditors in this study may have identified, for example, that the determination of cut-off dates for business transactions for the purpose of recording in the books of accounts, relate to the competency of management. Failing to appropriately identify cut-off in expenditure and income recognition may result in unreliable financial information.

Table 6.20 shows the summary of the results of the auditors' assessment revisions after reading the additional information. Most of the hypotheses are not supported particularly for the interaction effects. This indicates that auditors may consider honesty and competency separately in making judgments about the truth of audit assertions.

Studies have found that people compare behaviour to an "anchor". The experiment sets the initial honest and competent behaviour of financial controller as the "anchor" and subsequent information was given either confirming or disconfirming the initial behaviour. Theories on impression formation, particularly category-diagnosticity theory, suggest that auditors are more sensitive to negative cues than positive cues. Therefore, it is hypothesised that auditors' revisions to their assessments on whether an audit assertion is true will be negative or negative and larger when management is portrayed as consistently not honest or not competent compared to when management is consistently portrayed as honest or competent as proposed by H2a.

H2b proposes that auditors' revisions of their assessments of an audit assertion are negative or negative and larger when the financial controller is initially described as honest (or competent) and subsequently described as not honest (or not competent) than their revisions when the financial controller is initially described as not honest (or not competent).

H2c posits that auditors' assessment revisions on an audit assertion are negative or negative and larger when the financial controller is initially described as honest (or competent) and subsequently described as not honest (or not competent) than their revisions when the financial controller is consistently honest or consistently competent.

H2d posits that auditors' assessment revisions on an audit assertion are negative or negative and larger when the financial controller is consistently described as not honest or consistently described as not competent than their revisions when the financial controller is initially described as not honest (or not competent) and subsequently described as honest (or competent).

Table 6.20
Summary of the Results for the Differences between Initial and Second Assessments

Assertion	Initial Honest	Initial Competent	Consistent Honest	Consistent Competent	Initial Honest x Initial Competent	Initial Honest x Consistent Honest	Initial Honest x Consistent Competent	Initial Competent x Consistent Honest	Initial Competent x Consistent Competent	Initial Honest x Initial Competent x Consistent Honest	Initial Honest x Initial Competent x Consistent Competent
Completeness											
H2a	Not Supp	Not Supp	Not Supp	Not Supp	-	-	-	-	-	-	-
H2b	Not Supp	Not Supp	-	-	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp
H2c	-	-	-	-	-	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp
H2d	-	-	-	-	-	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp
H3a	-	-	-	-	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp
H3b	-	-	-	-	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp
Cut-off											
H2a	Not Supp	Supported	Not Supp	Supported	-	-	-	-	-	-	-
H2b	Not Supp	Supported	-	-	Supported	Supported	Not Supp	Supported	Not Supp	Not Supp	Not Supp
H2c	-	-	-	-	-	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp
H2d	-	-	-	-	-	Supported	Not Supp	Not Supp	Supported	Not Supp	Not Supp
H3a	-	-	-	-	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp
H3b	-	-	-	-	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp
Accuracy											
H2a	Not Supp	Not Supp	Not Supp	Not Supp	-	-	-	-	-	-	-
H2b	Not Supp	Not Supp	-	-	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp
H2c	-	-	-	-	-	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp
H2d	-	-	-	-	-	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp
H3a	-	-	-	-	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp
H3b	-	-	-	-	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp

Table 6.20 (continued)

Assertion	Initial Honest	Initial Competent	Consistent Honest	Consistent Competent	Initial Honest x Initial Competent	Initial Honest x Consistent Honest	Initial Honest x Consistent Competent	Initial Competent x Consistent Honest	Initial Competent x Consistent Competent	Initial Honest x Initial Competent x Consistent Honest	Initial Honest x Initial Competent x Consistent Competent
Overall Cash Transaction											
H2a	Not Supp	Not Supp	Not Supp	Not Supp	-	-	-	-	-	-	-
H2b	Not Supp	Not Supp	-	-	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp
H2c	-	-	-	-	-	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp
H2d	-	-	-	-	-	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp
H3a	-	-	-	-	-	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp
H3b	-	-	-	-	-	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp
Overall cash and cash equivalent balance											
H2a	Not Supp	Not Supp	Not Supp	Not Supp	-	-	-	-	-	-	-
H2b	Not Supp	Not Supp	-	-	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp
H2c	-	-	-	-	-	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp
H2d	-	-	-	-	-	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp
H3a	-	-	-	-	-	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp
H3b	-	-	-	-	-	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp	Not Supp

H2a is not supported except for the cut-off assertion. Auditors revise their initial assessments upward when the financial controller is initially described as competent and subsequently described as competent, and will revise downward when he is initially described as not competent and subsequently described as not competent, particularly for the cut-off assertion. However, for the second assessments, initial competency of the financial controller is significant for all the assertions. This indicates that auditors' revisions to their initial assessments after they read the information about the change in the competency of the financial controller are not significant, except for their assessments of the cut-off assertion.

H2b is not supported except for initial competency and the interactions between the financial controller's initial honesty and initial competency, initial honesty and consistency of honesty, and initial competency and consistency of honesty for the cut-off assertion. Auditors' revisions to their initial assessments are significantly larger when the financial controller is initially described as honest or competent and is not consistently described as honest or competent compared to when the financial controller is initially described as not honest or not competent and is subsequently described as honest or competent.

H2c is not supported for all of the assertions. Auditors' revisions to their initial assessments are not significantly larger when the financial controller is initially described as honest or competent and is not consistently described as honest or competent compared to when he is consistently described as honest or competent.

H2d is not supported except for the interaction between the financial controller's initial honesty and consistency of honesty for the cut-off assertion.

Category-diagnosticity theory proposes that perceptions of honesty are subject to a negativity bias and perceptions of competency to a positivity bias. Therefore, it is hypothesised in H3a that auditors' revisions to their assessments will be positive or positive and larger when the financial controller is consistently described as competent and when the financial controller is initially described as not competent and subsequently described as competent. H3b proposes that the assessment revisions will be negative or negative and larger when the financial controller is consistently described as not honest and when the financial controller is initially described as honest and subsequently described as not honest than when the financial controller is consistently described as competent and the financial controller is initially described as competent and subsequently described as not competent. No significant effect is found for the interaction between Consistent Honest and Consistent Competent. Therefore, auditors do not appear to be negatively biased in perceiving honesty and positively biased in perceiving competency.

The results from the present study are not consistent with previous findings that examine the schematic model of attribution (Reeder 1985) and category-diagnosticity model (Skowronski and Carlston 1987) of impression formation. There is evidence that auditors are influenced by the positive or negative descriptions of the financial controller's behaviour, but only in some conditions as discussed above. Auditors may be more focused and may rely on harder evidence rather than speculating about the implications of honest or not honest behaviour; or competent or not competent behaviour of financial controller. Even though there are studies that have shown auditors are more sensitive to client's integrity, these studies have been based mostly on survey method. Further, this study examines both honesty and competency, whereby the auditors consider both the honesty and competency of the client management in making their assessments of the audit assertions.

CHAPTER SEVEN

DISCUSSION AND CONCLUSIONS

7.1 Introduction

This chapter reiterates the motivation of this thesis and summarises the research findings of the survey and the behavioural experiment in Section 7.2. This is followed by Section 7.3, which discusses the implications of the findings of these studies. Section 7.4 reflects on some limitations of these studies. Section 7.5 concludes the chapter by highlighting some future research directions.

7.2 Motivation and Research Findings

Separately identifying fraud and error risk factors is crucial for the effective identification of fraud and error. This is because fraud detection procedures are different than error detection procedures. For the purpose of this thesis, error risk factors relate to the competency of an audit client's management, and fraud risk factors relate to their honesty. Client management is part of an entity's internal control environment and they have a direct impact on the truth and fairness of the entity's financial reporting. If the honesty and/or competency of client management are questionable, the company's financial report may not be reliable.

This thesis consists of two studies. The first study is based on a survey and the second study is a behavioural experiment. The survey is an exploratory study to investigate whether auditors appropriately identify management behaviours as being related to the honesty and competency of client management. The variables are extracted from actual fraud cases, guidelines from the auditing standards, and journal articles written on fraud and error risks. The findings from the survey confirm the findings from previous studies, i.e., that auditors do identify and classify the behaviours of client management into honesty and competency (Abdel-khalik et al. 1983; Brown 1983; Joyce and Biddle 1981a; Peecher 1996; Schneider 1984, 1985) and are able to assess fraud risk and error risk accordingly. However, the findings also show that auditors classify some honesty (fraud) risk factors as competency (error) risk factors. This should be a serious concern to the auditing profession because the implication is that fraud and error may not be discovered since incorrectly diagnosing a factor may lead to inappropriate audit procedures being performed. Therefore, it is suggested that auditors should be trained to correctly recognise client behaviours that signal dishonesty and incompetency.

To investigate the impact of honesty and competency factors on auditors' judgments, the second study uses a behavioural experiment. The purpose of this experiment is to examine the existence of biases in auditors' perceptions of the honesty and competency of client management, particularly the existence of a negativity bias in auditors' perceptions of honesty and a positivity bias in auditors' perceptions of competency. Theories on impression formation propose that negative information has more influence in the perceptions of behaviours than positive information.

Further, category-diagnosticity theory posits that people are negatively biased in perceiving honesty and positively biased in perceiving competency. The experiment is a case study consisting of a summary of two years' annual report for an actual company, whose name is disguised. The experiment is a 2 (initial honesty) x 2 (initial competency) x 2 (consistency of honesty) x 2 (consistency of competency) partial factorial between-subjects design. The participants are accountants and auditors attending a professional training course in the capital cities in Australia. They were given case materials that include background information of a client company and descriptions of its financial controller's honesty and competency. After reading this information, they were instructed to assess the truth of various audit assertions. After making their first set of assessments, they read additional information related to the financial controller's honesty and competency. After reading the additional information, they made a second assessment of the truth of the same assertions in the first judgment.

Theories on impression formation propose that negative cues have greater influence than positive cues in people's belief revision. For auditors' initial assessments, I find that initial honesty has a significant main effect for the completeness, cut-off and accuracy assertions. Thus, H1a is supported for these assertions. Initial competency has a significant main effect on auditors' initial assessments on the completeness, accuracy and overall cash transaction assertions and H1b is supported for these assertions. Further, the interaction of initial honesty and initial competency is significant only for the cut-off assertions, and therefore, H1c is supported for only the cut-off assertion.

With regard to the auditors' second assessments, I find that financial controller's initial honesty and consistency of honesty do not significantly affect auditors' assessments of the truth of all the assertions. The interaction between initial honesty and consistency of honesty significantly affects auditors' assessments for the completeness, cut-off and overall cash and cash equivalent balance assertions. Thus, H1a is not supported for the main effects of initial honesty and consistency of honesty, but is supported for the interaction between them for three assertions only.

The initial competency of the financial controller has a significant effect on auditors' assessments for all the assertions. However, his consistency of honesty has a significant main effect only for the auditors' second assessments for the cut-off assertion. The interaction between these variables has a significant effect on the auditors' assessments for the overall cash and cash equivalent balance assertion. H1b is supported for the cut-off assertion.

H1c is not supported for the interactions between initial honesty and initial competency, initial honesty and consistency of honesty and initial competency and consistency of competency. This indicates that auditors' assessments of honesty or dishonesty do not depend on whether the financial controller is competent or not competent. Similarly, auditors' assessments of the financial controller's competency or incompetency do not depend on whether he is honest or not honest.

For the differences in assessments, the financial controllers' initial honesty and consistency of honesty do not significantly affect auditors' assessments of the truth of the assertions for all the assertions. Initial competency of the financial controller also does not have a significant effect on auditors' revisions of assessments, except for the cut-off assertion. Similar results are found for consistent competency, where it has a significant effect for the cut-off assertion only. Thus, H2a is not supported. Consistently not honest or consistently not competent descriptions do not necessarily result in negative or negative and larger revisions than consistently honest or consistently competent descriptions.

H2b posits that when the financial controller is initially described as honest and is subsequently described as not honest, this results in negative or negative and larger revisions than when he is initially described as not honest and he is subsequently described as honest. However, this only occurs for the cut-off assertion. For the cut-off assertion, initial competency has a main significant effect but not initial honesty. The interactions between initial honesty and initial competency, initial honesty and consistency of honesty, and initial competency and consistency of honesty are significant for the auditors' assessment revisions. Initially describing the financial controller as honest or competent and he is not described to be consistently honest or competent does not necessarily result in larger revisions than initially describing him as not honest or not competent and subsequently describing him as honest or competent (i.e., he is not consistently described as not honest or not competent). Therefore, H2b is not supported.

Descriptions of the financial controller that initially portray him as honest and subsequently as not honest are hypothesised to result in larger revisions than when he is consistently described as honest (H2c). However this is not supported for all the assertions, where the interactions between initial honesty and consistency of honesty, initial honesty and consistency of competency, initial competency and consistency of honesty, and initial competency and consistency of competency are not significant. A negative change to honesty or competency (i.e., not consistently describing the financial controller as honest or competent) does not necessarily result in negative or negative and larger revisions than when he is consistently described as honest or competent.

H2d posits that consistently describing the financial controller as not honest and not competent will result in negative or negative and larger revisions to the assessments than when he is not consistently described as not honest or not competent. This is not supported for all the assertions, except for the cut-off assertion, where the interactions between initial honesty and consistency of honesty, and initial competency and consistency of competency significantly affect auditors' assessment revisions. These interactions are not significant for all the other assertions. Thus, H2d is not supported.

Category-diagnosticity theory proposes that people are negatively biased in perceiving honesty and positively biased in perceiving competency. These biases could impact auditors' judgments, which may then lead to auditors making inappropriate audit decisions. It is hypothesised in Hypothesis 3a that auditor's assessment revisions are negative or negative and larger when there is a positive change to the description of the financial controller's competency compared to when there is a positive change to the descriptions of his honesty, i.e., auditors are positively biased in perceiving competency. Hypothesis 3b posits that the assessments are negative or negative and larger when there is a negative change in the descriptions of the financial controller's honesty compared to a positive change in the descriptions of competency. The auditors display a negativity bias in perceiving the honesty of the financial controller, however, the results are not statistically significant. Therefore, the results do not support category-diagnosticity theory.

7.3 Implications of Study

The survey provides evidence that auditors do consider both the honesty and competency of an audit client's management in their judgments. This confirms the findings from previous studies that auditors are sensitive to the honesty and competency of an audit client's management. There are several differences between the current study and prior studies. The first difference is the variables used in the survey. The variables are focused on those factors relating to error risk and fraud risk, for example, *"There have been regular instructions from the chief accountant to transfer inventory to the equipment account"* to portray not honest behaviour by the client's management. Previous studies use variables that are not related to audit work (Anderson and Marchant 1989), for example, *"returned a lost wallet intact"* to portray an honest behaviour. In addition, the variables in the present survey consist of carefully selected behaviours of management that auditors would come across in their audit engagements. This study is also different from previous studies as it examines both honesty and competency simultaneously in a behavioural experiment, where both the honesty and competency of client management are built into each case. When honesty and competency are being evaluated at the same time, an evaluation of one could have an impact on the other.

The behavioural experiment tests cue-diagnosticity theory by examining the diagnosticity of information of an audit client's financial controller's honesty and competency. Consistent and inconsistent information of the financial controller's honesty and competency is manipulated in the experiment, where auditors make assessments of the truth of various audit assertions. The results from the behavioural experiment do not provide consistent evidence supporting the cue-diagnosticity model of impression formation. Auditors are not particularly more sensitive to negative cues than positive cues in their judgments. In other words, they are not negatively biased in perceiving honesty and not positively biased in perceiving competency.

However, it is noted that previous studies have not examined both honesty and competency in the same experiment when positivity and negativity biases are found. The present study presents both types of behaviours and for each audit assertion, the auditors were required to base their assessments on the descriptions about both the honesty and competency of the financial controller. Nevertheless, the lack of interactions between initial honesty and initial competency, initial honesty and consistency, and initial competency and consistency of honesty may indicate that auditors' perceptions of honesty do not depend on their perceptions of competency.

7.4 Limitations of Study

Like any other study performed in a controlled setting, this study has limitations. The results may not be representative of all external auditors. Many of the participants are junior auditors with limited audit experience. More experienced auditors may make different judgments than junior auditors. Previous studies suggest that more experienced auditors recall more errors and fewer incorrect items (Tubbs 1992); and more experienced auditors produce higher quality ethical judgments (Pflugrath et al. 2007).

The experiment is a partial factorial design, where subsequently similar behaviour is not tested. The excluded cells include the conditions where: (1) the financial controller is consistently described as both honest and competent; (2) the financial controller is consistently described as both not honest and not competent; (3) the financial controller is initially described as honest and not competent and the subsequent description also describes him as honest and not competent; and (4) the financial controller is initially described as not honest and competent and the second description also portrays him as not honest and competent. If a full factorial design, where all possible conditions are tested, had been used, different results might be obtained.

The behavioural experiment describes the honesty and competency of client management in written materials. As such, the behaviours were not witnessed directly by the participants. Even though written descriptions are an accepted method, auditors may respond differently to actual observations of client behaviour. In addition, experiments are useful in identifying potential influences and developing basic theory. Nevertheless, they are limited in their ability to determine the relative importance of the treatment variable in more complex field-based settings. The experiment only examines a company with a good internal control. The strength of internal control system may impact on auditors' judgments of client management behaviour. Different results could be obtained when clients have different levels of control risk.

7.5 Future Research

This study investigates the effects of the honesty and competency of client management on auditors' judgments for the cash cycle. Future research could investigate the impact of the honesty and competency of audit client management on other account balances and also on the overall financial statement level. Further, this study presents a case with a company's background that has a good internal control. Future research could investigate the effects of auditors' perceptions of client management honesty and competency with varying levels of control risk or could introduce other risk factors than those related to the honesty and competency of client management.

Experiments could also examine the impact of client honesty and competency on auditor's planning judgments. Audit techniques that are "forensic" in nature are required when auditor is suspicious of fraud in an audit of financial statements. Thus, it would be beneficial if research could investigate the effects of client honesty and competency on the nature and scope of audit evidence that auditors would plan to collect.

The results from the behavioural experiment are not consistent with the findings from previous research. However, previous research did not consider honesty and competency simultaneously, which is what the present study does. This could be the explanation for the differences in the findings. The present study can be extended to include more variations of the honesty and competency variables so that a more complete framework on client behaviours can be developed, which can assist auditors in their judgments.

Appendix 1

A list of honest and competent behaviours compiled from various sources. This list was then short-listed and only the most suitable behaviours were selected and included in the survey questionnaire

	Source: Comptronix (Boockholdt 2000)
1.	Valid accounts payable have been deleted two months before the year end and reinstated around middle of the financial year.
2.	There have been adjustments showing reduction in operating expenses and increase in inventory on monthly basis but no documentations exist to support these adjustments.
3.	Regular transfers from inventory to equipment accounts.
4.	No adjustments are made to start-up costs which have been capitalised.
5.	Termination of officer or director whom you know to have reasonable ethical conduct by the CEO.
6.	Related individuals (to the directors) sell their stocks in a subsidiary before the subsidiary was sold.
7.	Director is being investigated by the tax authority for allegedly reporting significantly less income tax.
	Source: Helecom Communications (Ballou and Mueller 2005)
8.	Directors draw modest salary from company but compensate from salaries from other companies that they privately owned
9.	Engaging companies that the Directors (and family) owned to do work at the company, for example, interior decoration service.
	Source: MicroStrategy, Inc. (Williams and Koch 2004)
10.	Directors have no accounting or finance background
11.	Directors employ aggressive accounting techniques
	Source: Bell Manufacturing Inc. (Keim and Grant 2003)
12.	You found that the chief financial officer had entered the country as illegal immigrant and asked you to keep this in confidence.
	Source: WorldCom (Zekany et al. 2004)
13.	The CEO has pledged his share holding in the company as collateral for loans to finance the purchase of his personal outside business interests.
14.	The corporate culture is which the leaders and managers are not to be questioned.
15.	Internal audit department are assigned projects which left the staff little time to perform audit functions.
16.	Adjustments made at the corporate level, which are not derived from operating activities, have not been made available to all managers.
17.	Managers have never received full monthly review from the directors.
18.	CEO/CFO regularly presses managers to reduce costs.
19.	The CFO was awarded Excellence Award and enjoyed a reputation of impeccable integrity
	Source: Waste Disposal Inc. (Ragothaman et al. 2003)
20.	The press reports that acquisitions by your client have been overpaid.
21.	Management implements cost-cutting plans to reduce operating expenses.
22.	Controller does not comply with GAAP.

	Source: Tallahassee BeanCounter (Durtschi 2003)
23.	Manager has been married several times to different women.
24.	Purchasing manager changed supplier to the one who seemed to be a good friend of his.
	Source: A city council case (Strand et al. 2002)
25.	Chief accountant never takes vacation and when employees are urged to take reasonable length of vacation each year, he took one day at a time.
26.	Invoices payable to supplier have not been processed in the usual manner.
27.	The senior accountant was unable to provide list of all fixed assets, plus the inventory identification number, date of purchase, cost, and current location of each item on the list. The excuse given was she had always been busy.
28.	Senior accountant always very busy and often arrives very early for work and leave the office rather late at night
29.	The current year's cash collections have declined. The staff accountant explained that there was a computer glitch in the individual accounts receivable software that created the need to reduce originally recorded amounts to their lower, correct totals.
30.	Customers complained about overdue notices. They said they have paid and had receipt to prove it. The staff accountant was unable to locate record of the accounts receivable.
31.	The senior accountant has filed for personal bankruptcy before because he had overextended his credit cards by taking too many cash advances.
	Source: HIH Insurance (Owen 2003)
32.	Directors are committed to attend the board of directors meetings and you observe that decision-making in these meetings is always thorough.
	Source: The AICPA (http://www.aicpa.org/InterestAreas/ForensicAndValuation/Resources/Pages/default.aspx)
33.	Suppliers are added to the vendors' list without proper verification
34.	Entering a purchase invoice into the accounting system without checking the authorisation of the invoice.
35.	Accounts manager is unable to answer auditor's questions as to why revenue has dropped.
36.	Accounts manager is unable to answer auditor's questions as to why there was a dramatic increase in miscellaneous income over the past year.
37.	Operation manager always approves immediately payments to some accounts but some other accounts payable are overdue for more than sixty days.
38.	The accounts manager recorded a purchase of fixed asset as expenditure.
39.	The chief accountant is having an affair with a staff.
40.	Approving non-related expenses (e.g. travelling expenses) as company's expenses.
41.	Having unrelated employee (e.g. secretary) to conferences for financial executives.
42.	Giving an expensive gift to an official in the process of negotiating a contract.
43.	Accounts payable and accounts receivable were not clean and reconciled.
44.	Sales orders received are recognised as sales.
45.	Expired inventory are still included in the valuation of inventory at its full costs.
46.	In inventory counting in a pharmaceutical company, more than half-full bottles of medicine are counted to the nearest 10% but less than half-full bottles are counted as half-full even though the content is very little.

	Source: ASA 240 (AuASB 2009a)
47.	Goods in transit to customers have been included in this year's income from sales.
48.	No authorisation to the adjustments of credit limits of customers.
49.	You vouched a sample of the recorded sales in the sales journal and find that there are a significant number of recorded sales which have no sales orders. When you asked the sales manager, he answered that these orders have been made electronically and provided you with a sample of the electronic order printouts.
50.	The provision for doubtful debt was reduced because the company has received, just before the year-end, a settlement from a substantial customer, whose account has been overdue for months.
51.	The sales clerk who made adjustments to the credit limit of a few customers.
52.	The carbon copies of sales vouchers contain original writings adjusting the amounts of credit sales being made on some of them.
53.	Some of the purchase orders have no original copies of except for photocopies.
54.	Manager unable to explain to discrepancies from the reconciliation of shipping and billing documents.
55.	There are discrepancies between accounts receivable balances and debtors' confirmations.
56.	Significant amount of inventory or physical assets are missing
57.	Auditors are not provided with complete vendors' addresses even after a few requests.
58.	Management complains that auditors ask too many questions.
59.	Management is very slow in providing the information requested by auditors.
60.	It is very difficult for auditors are unable access electronic files to carry out computerised audit.
61.	There are frequent changes to the accounting estimates which are not accompanied by changes in circumstances.
62.	Auditors are not invited and informed about directors' meeting.
63.	Management has not rectified weaknesses in internal control which have been reported in the previous audit.
64.	Unwillingness to address identified deficiencies in internal control on a timely basis
	Source: Monroe et al. (1993)
65.	Management has a reputation for taking unusual business risks.
66.	Management has been reluctant to accept auditor's adjustments.
67.	There are errors made in the recording of account receivable.
68.	There have been errors in inventory pricing.
69.	Estimates for the provision of doubtful debts have not been accurate.
70.	Management is not experienced or trained in accounting.
71.	Management is inexperienced and lack knowledge.
72.	Management is in dispute with top management over inventory policies.
73.	Auditors disagreed with management's estimate of obsolete inventory in past audits.
74.	A complicated formula is used in the calculation of overheads for inventory.
75.	The company supplies significant portion of its inventory to its subsidiaries.
76.	The collection pattern for accounts receivable has changed significantly over the past year.

Appendix 2
Details of Survey Questionnaire

ANU	**School of Accounting and Business Information** **College of Business and Economics** **Copland Building 024** **The Australian National University** **ACT 0200** **Telephone: 02 6125 4791 / 02 6125 3807** **Facsimile: 02 6125 0744**

Dear Sir/Madam

INVITATION TO PARTICIPATE IN A PRELIMINARY SURVEY OF FACTORS AFFECTING AUDITOR'S ASSESSMENT OF CLIENT MANAGEMENT HONESTY AND COMPETENCY

I am a PhD candidate at the Australian National University, Canberra. This survey is a part of my PhD thesis examining factors that affect the assessment of honesty and competency of client management. The objective of this survey is to gain a general consensus on what can be constituted as honesty and competency from an auditor's perspective. I would like you to participate in this survey.

The findings from this survey will be used in the second phase of my research. Your response to this survey and any other information you provide will be kept confidential. I will take the necessary steps to ensure this. If you agree to participate, please read the information sheet and sign the consent letter. Please retain the information sheet.

I would appreciate it very much if you could complete and return the survey together with the consent form. I thank you for your cooperation and look forward to your reply soon.

Yours sincerely,

____

ROSZANA TAPSIR
PhD Candidate

School of Accounting and Business Information
College of Business and Economics
Copland Building 024
The Australian National University
ACT 0200
Telephone: 02 6125 4791 / 02 6125 3807
Facsimile: 02 6125 0744
E-mail: **Roszana.Tapsir@anu.edu.au**

Information Sheet

A Survey on Factors Affecting Auditors' Assessments of Honesty and Competency of Audit Client Management
Research by Roszana Tapsir
(a PhD candidate at the Australian National University)

Please read this sheet carefully and keep it throughout the study.

This is a preliminary survey examining factors that affect auditors' assessment of honesty and competency of client management. The objective of this survey is to gain a general consensus on what can be constituted as honesty and competency from an auditor's perspective. This survey should not take more than 30 minutes to complete. The findings from this survey will be used in the second phase of the research. Please complete the survey as per the instructions. Your responses to the questions in this survey will be treated with the strictest confidentiality.

Please note the following:

- Your participation is on a voluntary basis therefore, you are free to withdraw from the study without any prejudice in any way. In such case, the record of your participation will be destroyed, unless you agree otherwise.
- All the information you provide will be treated with the strictest confidentiality, where individual responses will not be identifiable.
- The responses will be preserved and kept confidential to the extent permissible by law.
- The result of this study will be part of a research thesis and part of a journal article. However, no information on any individual will be reported in a way that will allow identification of individual participants.
- The researcher will answer any questions you may have with regard to the study. Any complaint or other issues of concern can be directed to the researcher or to Ms Yolanda Shave, Human Research Ethic Officer, Research Services Office, Australian National University, (telephone number 6125 7945) or email Human.Ethics.Officer@anu.edu.au. Please keep this Information Sheet for your personal records.

School of Accounting and Business Information
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The Australian National University
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Consent Form

A Survey on Factors Affecting Auditors' Assessments of Honesty and Competency of Audit Client Management
Research by Roszana Tapsir
(a PhD candidate at the Australian National University)

I ______________________________ have read and understand the information provided. I hereby consent to take part in the survey and understand that I may withdraw without any reason unspecified and without prejudice.

I understand that the information provided by me will be kept confidential so far as the law allows and only the researcher will have access to the data entered into a computer with no link to my personal details.

I understand that the information gained during the experiment will be reported as a thesis result and may be published in a journal article. Every reasonable effort will be made to ensure that no information that identifies my personal details will be published or disclosed to any report and any of those publications without my prior permission.

____
Participant Date

Any complaint or other issues of concern can be directed to the researcher or to Ms Yolanda Shave, Human Research Ethic Officer, Research Services Office, Australian National University, (telephone number 6125 7945) or email Human.Ethics.Officer@anu.edu.au.

THE AUSTRALIAN NATIONAL UNIVERSITY

SURVEY OF AUDITORS' PERCEPTIONS OF HONESTY AND COMPETENCY OF CLIENT MANAGEMENT

Roszana Tapsir
PhD Candidate
School of Accounting and Business Information Systems
College of Business and Economics
Copland Building 024
The Australian National University
ACT 0200
Telephone: 02 61254791
Email: Roszana.Tapsir@anu.edu.au

INSTRUCTIONS

Thank you for participating in this survey.

As you are aware, auditing standards require auditors to assess the honesty and competency of client management (ASA240 and ASA315). Despite their importance, there is little knowledge of what factors affect auditors' assessments of the client management honesty and competency. As indicated in the attached letter, this is a preliminary survey for my PhD thesis. Its objective is to gain a general consensus on what can be constituted as honesty and competency when assessing the audit client's management. The findings from this survey will be used in the second phase of my research.

This survey should not take more than 30 minutes. It consists of Parts 1 and 2. Please complete both parts.

For Part 1, you are required to:
1. Read the circumstance in the first column; and
2. Assess whether the circumstance is **more likely** to indicate honesty or competency of the auditee [Question (a)] by circling either H (if you think the circumstance is **more likely** to indicate honesty) or C (if you think the circumstance is **more likely** to indicate competency); or N (if you think it indicates neither honesty nor competency); and
3. Assess whether the circumstance contributes to low or high risk of fraud or error in the financial statements [Question (b)] and circle the appropriate number to indicate the level of risk that you think the circumstance represents.

The circumstances are independent. Please treat them separately. These circumstances may not be representative of what you normally encounter. However, based on your experience, please assess whether each one is **more likely** to indicate honesty or competency of your audit client.

Part 2 asks you to provide information on your background.

I would be most grateful if you will complete the survey and return it to me by Monday, **21 May 2007**.

Your responses to the questions and other information you provide will remain confidential to me and will be used only for the purpose of my research.

Please now proceed with the survey. Thank you again for your participation.

Roszana Tapsir
PhD Candidate
Australian National University

PART 1

Circumstances involving management or those charged with governance of the audit client	Question (a) Does the circumstance indicate honesty or competency of the auditee? (Circle either H or C or N)			Question (b) Does the circumstance contribute to low or high risk of fraud or error in the financial statements? (Circle the appropriate number).						
	Honesty	Competency	Neither	Low Risk						High Risk
1. The accounts manager is unable to answer your questions as to why there has been a dramatic increase in miscellaneous income over the past year.	H	C	N	1	2	3	4	5	6	7
2. There have been adjustments showing a reduction in operating expenses and an increase in inventory on a monthly basis but no documentation exists to support these adjustments.	H	C	N	1	2	3	4	5	6	7
3. There have been regular instructions from the chief accountant to transfer inventory to the equipment account.	H	C	N	1	2	3	4	5	6	7
4. Individuals related to the directors sell their shares in a subsidiary before the subsidiary was sold.	H	C	N	1	2	3	4	5	6	7

Circumstances involving management or those charged with governance of the audit client	**Question (a)** **Does the circumstance indicate honesty or competency of the auditee? (Circle either H or C or N)**			**Question (b)** **Does the circumstance contribute to low or high risk of fraud or error in the financial statements? (Circle the appropriate number).**						
	Honesty	Competency	Neither	Low Risk						High Risk
5. The CEO terminated the vice president and a director who questioned the CEO's action to capitalise start-up costs with the intention to maintain or increase the stock price and earnings.	H	C	N	1	2	3	4	5	6	7
6. The directors engage companies that they (and their families) own to do work for the company, for example, interior decoration service.	H	C	N	1	2	3	4	5	6	7
7. A director is being investigated by the Australian Tax Office for allegedly reporting significantly less personal income.	H	C	N	1	2	3	4	5	6	7
8. The purchasing manager added suppliers to the vendors' list without proper verification.	H	C	N	1	2	3	4	5	6	7

Circumstances involving management or those charged with governance of the audit client	Question (a) Does the circumstance indicate honesty or competency of the auditee? (Circle either H or C or N) Honesty	Competency	Neither	Question (b) Does the circumstance contribute to low or high risk of fraud or error in the financial statements? (Circle the appropriate number). Low Risk						High Risk
9. The manager is unable to explain discrepancies arising from the reconciliation of shipping and billing documents.	H	C	N	1	2	3	4	5	6	7
10. The CEO and CFO have not made available to all managers reports on adjustments made at the corporate level, which are not derived from operating activities.	H	C	N	1	2	3	4	5	6	7
11. A significant amount of physical inventory is missing.	H	C	N	1	2	3	4	5	6	7
12. Management has not rectified weaknesses in internal control that have been reported in the previous audit.	H	C	N	1	2	3	4	5	6	7
13. The credit manager has not been observing the policy to authorise the adjustments of customers' credit limits.	H	C	N	1	2	3	4	5	6	7

Circumstances involving management or those charged with governance of the audit client	Question (a) Does the circumstance indicate honesty or competency of the auditee? (Circle either H or C or N)			Question (b) Does the circumstance contribute to low or high risk of fraud or error in the financial statements? (Circle the appropriate number).						
	Honesty	Competency	Neither	Low Risk						High Risk
14. Directors are committed to attend the board of directors meetings and you observe that decision-making in these meetings is always thorough.	H	C	N	1	2	3	4	5	6	7
15. Management is very slow in providing the information that you request.	H	C	N	1	2	3	4	5	6	7
16. The purchasing manager changed suppliers to the one who appeared to be a good friend of his.	H	C	N	1	2	3	4	5	6	7
17. The chief accountant never takes vacation and when employees are urged to take reasonable length of vacation each year, he took one day at a time.	H	C	N	1	2	3	4	5	6	7
18. Invoices payable to a particular supplier have not been processed in the usual manner.	H	C	N	1	2	3	4	5	6	7

Circumstances involving management or those charged with governance of the audit client	Question (a) Does the circumstance indicate honesty or competency of the auditee? (Circle either H or C or N)			Question (b) Does the circumstance contribute to low or high risk of fraud or error in the financial statements? (Circle the appropriate number).						
	Honesty	Competency	Neither	Low Risk						High Risk
19. The CFO confided to you that he entered the country as an illegal immigrant and asked you to keep this in confidence.	H	C	N	1	2	3	4	5	6	7
20 The CFO has more than 10 years of experience in the industry.	H	C	N	1	2	3	4	5	6	7
21. The CEO has pledged his shares in the company as collateral for loans to finance the purchase of his personal outside business interests.	H	C	N	1	2	3	4	5	6	7
22. The senior accountant has been unable to provide a list of all fixed assets, asset identification numbers, cost, date of purchase, and current location of each item on the list. The excuse given is she has always been busy.	H	C	N	1	2	3	4	5	6	7

Circumstances involving management or those charged with governance of the audit client	**Question (a)** **Does the circumstance indicate honesty or competency of the auditee? (Circle either H or C or N)**			**Question (b)** **Does the circumstance contribute to low or high risk of fraud or error in the financial statements? (Circle the appropriate number).**						
	Honesty	Competency	Neither	Low Risk						High Risk
23. The sales manager sometimes made adjustments to the amounts of credit sales in writing on some of the carbon copies of sales vouchers.	H	C	N	1	2	3	4	5	6	7
24. You have not been provided with a complete list of vendors' addresses even after a few requests.	H	C	N	1	2	3	4	5	6	7
25. The Financial Controller does not comply with GAAP on some material matters	H	C	N	1	2	3	4	5	6	7
26. Customers complain about overdue notices. They say they have paid and have receipts to prove it. The staff accountant is unable to locate records of the related accounts receivable.	H	C	N	1	2	3	4	5	6	7

Circumstances involving management or those charged with governance of the audit client	Question (a) Does the circumstance indicate honesty or competency of the auditee? (Circle either H or C or N) Honesty	Competency	Neither	Question (b) Does the circumstance contribute to low or high risk of fraud or error in the financial statements? (Circle the appropriate number). Low Risk						High Risk
27. The accounts manager is always ready with satisfactory answers when asked about fluctuations in revenue.	H	C	N	1	2	3	4	5	6	7
28. The financial director gives an instruction to delete valid accounts payable two months before the year end and reinstate them around middle of the financial year.	H	C	N	1	2	3	4	5	6	7
39. The accounts manager processes vouchers for payments without checking for authorisation.	H	C	N	1	2	3	4	5	6	7
30. Top management has been in dispute with you, the auditor, over inventory policies.	H	C	N	1	2	3	4	5	6	7
31. The credit manager is unable to explain discrepancies between accounts receivable balances and debtors' confirmations.	H	C	N	1	2	3	4	5	6	7

Circumstances involving management or those charged with governance of the audit client	Question (a) Does the circumstance indicate honesty or competency of the auditee? (Circle either H or C or N)			Question (b) Does the circumstance contribute to low or high risk of fraud or error in the financial statements? (Circle the appropriate number).						
	Honesty	Competency	Neither	Low Risk						High Risk
32. The chief accountant is having an affair with an employee.	H	C	N	1	2	3	4	5	6	7
33. The CEO and CFO purposely assign the internal audit department projects that leave the staff little time to perform audit functions.	H	C	N	1	2	3	4	5	6	7
34. Some purchase orders have no original copies, just photocopies.	H	C	N	1	2	3	4	5	6	7
35. A director gives an expensive gift to a third party in the process of negotiating a contract.	H	C	N	1	2	3	4	5	6	7
36. Accounts payable and accounts receivable are not reconciled.	H	C	N	1	2	3	4	5	6	7
37. Expired inventory are still included in the valuation of inventory at full cost.	H	C	N	1	2	3	4	5	6	7

Circumstances involving management or those charged with governance of the audit client	Question (a) Does the circumstance indicate honesty or competency of the auditee? (Circle either H or C or N)			Question (b) Does the circumstance contribute to low or high risk of fraud or error in the financial statements? (Circle the appropriate number).						
	Honesty	Competency	Neither	Low Risk						High Risk
38. The financial controller tells the auditor his concern about a weakness in the control system.	H	C	N	1	2	3	4	5	6	7
39. Management approves non-related expenses (e.g., personal travelling expenses) as a company expenses.	H	C	N	1	2	3	4	5	6	7
40. The accounts manager returns vouchers for payment, without proper authorisation to the purchasing department.	H	C	N	1	2	3	4	5	6	7
41. The CFO is inexperienced and lacks knowledge of the industry.	H	C	N	1	2	3	4	5	6	7
42. Sales orders received are recognised as sales immediately.	H	C	N	1	2	3	4	5	6	7

Circumstances involving management or those charged with governance of the audit client	Question (a) Does the circumstance indicate honesty or competency of the auditee? (Circle either H or C or N)			Question (b) Does the circumstance contribute to low or high risk of fraud or error in the financial statements? (Circle the appropriate number).						
	Honesty	Competency	Neither	Low Risk						High Risk
43. The chief accountant reduced the provision for doubtful debts because the company received, just before the year-end, a settlement from a substantial customer, whose account had been overdue for months.	H	C	N	1	2	3	4	5	6	7
44. The accounts manager recorded the purchase of a fixed asset as an expense.	H	C	N	1	2	3	4	5	6	7
45 The CFO has a reputation of impeccable integrity and has won a CFO Excellence Award.	H	C	N	1	2	3	4	5	6	7
46. Four years ago, the senior accountant filed for personal bankruptcy because he had overextended his credit cards by taking too many cash advances.	H	C	N	1	2	3	4	5	6	7

Circumstances involving management or those charged with governance of the audit client	Question (a) Does the circumstance indicate honesty or competency of the auditee? (Circle either H or C or N)			Question (b) Does the circumstance contribute to low or high risk of fraud or error in the financial statements? (Circle the appropriate number).						
	Honesty	Competency	Neither	Low Risk						High Risk
47. Management does not assist you in accessing electronic files to carry out computerised audit procedures.	H	C	N	1	2	3	4	5	6	7
48. Half of the directors have been absent from board meetings, and, when they are there, they do not contribute significantly in the discussions.	H	C	N	1	2	3	4	5	6	7

PLEASE TURN OVER

PART 2

1. Please indicate your gender.
   (Tick the appropriate box)
   Male ☐
   Female ☐

2. How many years of audit-related experience do you have?
   __________ years

3. Have you held any of these positions?
   (Tick all those that are applicable)
   Audit staff ☐
   Senior auditor ☐
   Audit partner ☐
   Audit manager ☐
   Internal auditor ☐
   Audit committee member ☐
   Other ☐
   (Please specify): ____________________________

4 Your current position
   (Tick only ONE box)
   Audit staff ☐
   Senior auditor ☐
   Audit partner ☐
   Audit manager ☐
   Internal auditor ☐
   Audit committee member ☐
   Other ☐
   (Please specify): ____________________________

5. Have you worked (or are you working) with any of the following firm type?
   (Tick all those that appropriate)
   Big-4 ☐
   Medium size firm ☐
   Small firm ☐
   Other ☐
   (Please specify) ______________________

APPENDIX 3
Details of Behavioural Experiment

ANU

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Copland Building 024
The Australian National University
ACT 0200
Telephone: 02 6125 4791 / 02 6125 3807
Facsimile: 02 6125 0744

1 August 2008

Dear Sir/Madam

INVITATION TO PARTICIPATE IN A CASE STUDY ON ASSESSMENTS OF AUDIT ASSERTIONS

I am a PhD candidate at the Australian National University, Canberra. This case study is the second phase of my PhD thesis examining auditors' judgments in the assessments of audit assertions. This case study is supervised by Professor Gary Monroe from the School of Accounting and Business Information Systems, College of Business and Economics, the Australian National University. He may be contacted at 02 6125 5906 or through email: gary.monroe@anu.edu.au

Your response to the questions in this case study is essential in the study of audit judgments and thus will contribute to the audit profession in general. Your response in this case study and any other information you provide will be kept confidential. I will take the necessary steps to ensure this. If you agree to participate, please read the information sheet.

Please indicate your acknowledgment of the receipt of $20 shopping voucher after completing the case study. I thank you for your cooperation and look forward to your reply soon.

Yours sincerely,

____

ROSZANA TAPSIR
PhD Candidate

ANU	School of Accounting and Business Information College of Business and Economics Copland Building 024 The Australian National University ACT 0200 Telephone: 02 6125 4791 / 02 6125 3807 Facsimile: 02 6125 0744

Information Sheet

A Case Study on Assessments of Audit Assertions.

Research by Roszana Tapsir
PhD candidate

Supervised by Prof. Gary Monroe
School of Accounting and Business Information Systems
College of Business and Economics
The Australian National University
Telephone: 02 6125 5906
Email: gary.monroe@anu.edu.au

Please read this sheet carefully and keep it throughout the study.

This behavioural experiment is the second phase of my research work. The first phase was a survey questionnaire. The results from the survey are used in this experiment. The objective of this case study is to examine auditors' judgments in the assessments of audit assertions. The findings are expected to impact on the process which judgments are made. The findings are also expected to improve the effectiveness and efficiency of these judgments. Even though the extant literature on auditors' judgments is extensive, little is known about this important aspect.

This case study should take not more than 20 minutes to complete. Please complete the case study as per the instructions. Your responses in this case study will be treated with the strictest confidentiality.

Please note the following:

- Your participation is on a voluntary basis therefore, you are free to withdraw from the study without any prejudice in any way. In such case, the record of your participation will be destroyed, unless you agree otherwise.
- All the information you provide will be treated with the strictest confidentiality, where individual responses will not be identifiable.
- The responses will be preserved and kept confidential to the extent permissible by law.
- The result of this study will be part of a research thesis and part of a journal article. However, no information on any individual will be reported in a way that will allow identification of individual participants.

The researcher will answer any questions you may have with regard to the study. Any complaint or other issues of concern can be directed to the researcher or to Ms Yolanda Shave, Human Research Ethic Officer, Research Services Office, Australian National University, (telephone number 6125 7945) or email Human.Ethics.Officer@anu.edu.au. Please keep this Information Sheet for your personal records.

THE AUSTRALIAN NATIONAL UNIVERSITY

A CASE STUDY ON THE ASSESSMENTS OF AUDIT ASSERTIONS

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A CASE STUDY ON THE ASSESSMENTS OF AUDIT ASSERTIONS

Thank you for participating in this research.

As indicated in the attached letter, this is the second phase of my PhD research. The objective is to examine the assessments of audit assertions.

Your responses to the questions and other information you provide will remain confidential to me and will be used only for the purpose of my research.

Please now proceed with the case study. Thank you again for your participation.

Roszana Tapsir
PhD Candidate
The Australian National University

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A summary of the outcome of this research can be provided to you if you wish. Please provide your contact address (email or postal address) below. Please tear off this portion and submit it separately.

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General Instructions

Please read carefully the following instructions before you actually complete the case study which is presented from pages 4 to 15.

- This case study will take approximately 20 minutes to complete.

- The responses you give should represent your individual judgment. Please do not discuss the case materials with anyone else.

- This case study consists of three parts as follows:
    - Part 1: Information for an audit client.
    - Part 2: Additional information and audit evidence relating to specific audit assertions.
    - Part 3: Debriefing questions.

This study examines auditors' judgments in the assessments of audit assertions. In this case, you are asked to assess whether particular audit assertions are true or false given audit evidence. The evidence will include the background information of an audit client company and audit evidence obtained during the audit. Your judgment will be in the form of circling a number on a seven-point rating scale that indicates how strongly you believe that the assertion is true or not true. The scales are anchored by "Strongly believe that the assertion is NOT true" and "Strongly believe that the assertion is true".

Please proceed with the case study.

Part 1: Audit of Telcom Ltd

Telcom Ltd is a mobile communication retail company. Telcom has been the audit client of your firm since it became a publicly listed company in 2005. Under the audit agreement between your firm and Telcom, you must provide assurance as to whether the financial statements present fairly the financial position and the results of operations. You are currently working on the audit of Telcom and you want to verify if the cash and cash equivalent balance on the 2008 balance sheet is fairly presented.

As part of your audit of the Cash at Bank Account and the underlying related cash transactions, you obtained evidence about the following three assertions.

Assertion 1: All cash transactions have been recorded (Completeness).

Assertion 2: Cash transactions have been recorded in the proper period (Cut-off).

Assertion 3: Cash transactions have been recorded using the proper amounts. (Accuracy).

The following pages contain information about Telcom Ltd.

Background Information
Telcom Ltd

Telcom's first store was opened in 1995. Telcom has grown rapidly from a single Gold Coast store in 1995 to almost 150 retail locations around the country. It maintains its head office in the Gold Coast. Telcom Ltd is now the largest specialist mobile communications retailer and is the largest independent Telstra mobile dealer. It successfully listed on the Australian Stock Exchange (ASX) on 2 November 2005. So far, Telcom has 127 stores, and 23 nominated dealers, including some licensed shops with Telstra. The latest acquisition from Telstra is one of Telstra biggest mobile dealers, OZ One, which was agreed on 2 Julyt 2008. OZ One is a mobile phone retailer and has 15 stores in Western Australia, making this acquisition Telcom's biggest project involving the standardisation and improvements of the operation of the nominated dealer channels.

Telcom has achieved double digit compounded growth over the last 10 years. The year 2008 has been another successful year for Telcom with:

- total operating revenue of $181.8 million, an increase of almost 20% from the previous financial year;
- net profit after tax (NPAT) of $10.7 million, an increase of 26% from the previous year;
- earnings before interest and taxation (EBIT) of $17.4 million, an increase of almost 30% from the previous year.

The following are figures for earnings per share and other financial measures of the return to shareholders:

	2008	2007
Basic earnings per share (cents)	8.59	6.90
Return on equity	68.6%	50.0%
Debt/equity ratio	42.5%	84.7%

In his report, the Chairman states that Telcom is in position to grow and expects to improve profit performance in the 2009 financial year. There are plans to open 8 to 10 more stores in addition to OZ One. The results for the first half of 2009 are expected to be similar to the 2008 first half due to costs associated with the integration of OZ One and an anticipated drop in Telstra transition payments. The company aims to maintain gearing below 50% and the Board considers that the current level of gearing of 42.5% is well within acceptable limits.

Revenue and profit figures for the recent three years are as follows:

	2008	2007	2006
	$m	$m	$m
Revenue from operating activities	181.8	151.9	144.9
EBIT	17.4	13.4	16.0
Net profit after tax	10.7	8.6	9.6

On 2 July 2008, the company agreed to purchase OZ One for $6 million, to be funded from cash reserves.

On 5 July 2008, the company declared a fully franked dividend of 4 cents per share. This amounted to $5,005,912. This dividend has not been provided for in the 30 June 2008 financial statements.

The financial year ended 30 June 2008 was one of the most competitive and changing environments for the mobile communications industry, with the launches of various arrays of products by other major service providers. These market conditions resulted in Telcom implementing significant product shifts throughout the year.

The company has in place a statement of corporate governance. This statement is in accordance with the Australian Securities Exchange Corporate Governance Council's (ASXCGC) Principles of Good Corporate Governance Practice and Best Practice Recommendations (Guidelines). This statement consists of among other things: the requirement to disclose any director's interests; independence of directors are assessed regularly; employees and directors to make ethical and responsible decisions; and the CEO and CFO are required to state in writing that the financial reports are produced with integrity.

Executive Directors receive fixed remuneration. Under the Executive Service Agreement, they are also entitled to an annual salary review and bonus based on the performance of their duties and obligations. Bonus payments to key managers are at the discretion of the Executive Directors who take into account the Company and individual performance against key performance indicators. In compliance with the ASXCGC recommendations, Telcom established a Remuneration and Nomination Committee. The majority of the members are independent directors.

Your firm has been auditing Telcom since it became a publicly listed company and has issued an unqualified audit opinion on the financial statements of Telcom. Based on the prior year's financial statements and the review of results of 2007 audit, materiality has been set at $2,000,000 for balance sheet items and $1,000,000 for income statement items this year.

In performing your audit of Telcom, you work very closely with Mr Adam Stewart, the Financial Controller. Mr Stewart always expresses his concerns whenever he feels that some aspects of internal control are not observed. Telcom's internal control is assessed as moderate. However, in most cases where breakdowns have been observed in Telcom's internal control procedures in past audits, and with Mr Stewart's help, you were able to perform related substantive audit procedures to identify any material misstatements that might exist in the accounts.

Your current year's audit also revealed that there were a number of sales invoices included in the current year's results for product sales that were actually delivered on the first two days of the next financial year despite the fact that title to the goods did not transfer until the goods were delivered to the customer. The items had not been included in inventory, but the profit on these sales had effectively been "anticipated". The effect was a material increase in profit. Mr Stewart refused to reverse the sales as he argued there was no question about whether the profits were real or not, it was just a matter of one or two day's timing. Subsequent discussions with Mr Stewart indicated to you that he was not aware that title to the goods did not transfer until the goods were delivered to the customer.

The following pages contain Telcom's summary of financial statements that consist of the income statements for the years ended 30 June 2007 and 2008, balance sheets as at those dates and cash flow statements for those years.

Summary of Financial Statements
Income Statement for the year ended 30 June

	2008 (Unaudited) $'000	2007 (Audited) $'000
Sale of goods	129,376	110,242
Fee revenue	30,819	17,473
Commission revenue	20,874	23,110
Other Revenue	734	1,070
	181,803	151,895
Cost of sales	(92,971)	(79,962)
Gross profit	88,832	71,933
Other income	3,890	3,633
Employee benefit expense	(47,304)	(36,485)
Marketing expenses	(4,108)	(4,737)
Operating lease rental expense	(10,942)	(8,551)
Depreciation and amortisation expense	(4,511)	(3,538)
Other expenses	(8,491)	(8,880)
Finance costs	(852)	(559)
Profit before income tax	16,514	12,816
Income tax expense	(5,773)	(4,265)
Net profit for the year	10,741	8,551
Earnings per share (cents per share)		
- basic profit for the year	8.59	6.90
Dividends paid per share (cents per share)		8

Balance Sheet
As at 30 June

	2008 (Unaudited) $'000	2007 (Audited) $'000
Assets		
Current Assets		
Cash and cash equivalent	12,038	3,657
Trade and other receivables	13,040	10,745
Inventories	7,050	6,368
Prepayments	1,009	794
Total Current Assets	33,137	21,564
Non-current Assets		
Other financial assets	576	546
Available for sale investments	0	2
Deferred tax asset	2,514	2,136
Plant and equipment	11,614	9,399
Intangible assets and goodwill	16,184	17,014
Total Non-current Assets	30,888	29,097
Total Assets	64,025	50,661
Liabilities		
Current Liabilities		
Trade and other payables	17,765	15,106
Interest bearing loans and borrowings	2,601	2,683
Deferred tax liabilities	1,807	454
Provisions	2,716	2,559
Total Current Liabilities	24,889	20,802
Non-current Liabilities		
Trade and other payables	565	672
Interest bearing loans and borrowings	8,807	10,571
Deferred tax liabilities	1,170	1,546
Provisions	1,750	1,416
Total Non-current Liabilities	12,292	14,205
Total Liabilities	37,181	35,007
Net Assets	26,844	15,654
Equity		
Contributed equity	4,128	4,128
Retained earnings	22,267	11,526
Reserve	449	0
Total Equity	26,844	15,654

Cash Flow Statement
For the year ended 30 June

	2008 (Unaudited) $'000	2007 (Audited) $'000
Cash flows from operating activities		
Receipts from customers	179,508	169,566
Payments to suppliers and employees	(151,332)	(154,289)
Interest received	734	1,070
Finance costs	(852)	(559)
Income tax paid	(4,553)	(9,737)
Net GST remitted	(5,440)	(5,405)
Net cash flow from/(used in) operating activities	18,065	646
Cash flows from investing activities		
Proceeds from the sale of plant and equipment	92	135
Proceeds from the disposal of investment	6	0
Repayments of advances to shareholders	292	(292)
Purchase of plant and equipment	(4,907)	(922)
Purchase of intangibles	(359)	(179)
Acquisition of subsidiary, net of cash required	79	(16,928)
Purchase of interest bearing deposits	(30)	1,124
Net cash flow from/(used in) financing activities	(4,827)	(17,062)
Cash flows from financing activities		
Proceeds from borrowings	345	18,450
Repayments of borrowings	(3,469)	(10,701)
Repayment of finance lease principal	(1,733)	(1,602)
Equity dividends paid	0	(10,000)
Net cash flow from/(used in) financing activities	(4,857)	(3,853)
Net increase/(decrease) in cash and cash equivalents	8,381	(20,269)
Cash and cash equivalents at beginning of period	3,657	23,926
Cash and cash equivalents at end of period	12,038	3,657

Part 2: Assessments of Audit Assertions

For this part, please provide your assessments on the audit assertions. Your judgment will be in the form of circling a number on a seven-point rating scale that indicates how strongly you believe that the assertion is true or not true. The scales are anchored by "Strongly believe that the assertion is NOT true" and "Strongly believe that the assertion is true". The following pages describe some of the audit procedures and the audit evidence you have obtained relating to the determination of the three assertions. In stating your assessment on one audit assertion, you should take into consideration only (1) audit evidence regarding that particular audit assertion and (2) the background information.

To verify Assertion 1 (Completeness):

You were examining inter-company transfers made by Telcom to its subsidiaries. You paid particular attention to transfers made during the month of June 2008. Inter-company transfers that took place during that month totalled \$3,150,000. You came across two transfers of \$48,450 made to a subsidiary that appeared in the bank statements for June 2008 but were not recorded anywhere in Telcom's books of accounts. You made an inquiry to that subsidiary. However, the accountant from the subsidiary could not verify that they had received the transfer. You discussed this with the Financial Controller, Mr Stewart, who assures you that this is simply a bank error and the two "transfers" will be corrected by the bank next month.

Your assessment about Assertion 1: All cash transactions have been recorded.						
1	2	3	4	5	6	7
Strongly believe that the assertion is NOT true						Strongly believe that the assertion is true

To verify Assertion 2 (Cut-off):

In addition to examining unpresented cheques that appeared in the bank reconciliation for the month of June 2008, you also examined the cheques that had been drawn but were not mailed during the same month. You were surprised to find that some of the cheques listed as unpresented in the bank reconciliation for the month of June 2008 had not been mailed to suppliers. The total of these cheques was $1,055,200 and the unpresented cheques listed in the bank reconciliation for the last month of the financial year totalled $3,450,000. You discussed this with Mr Stewart because you understood that one of the debt covenants attached to Telcom's long term borrowing involved the company's current ratio. Mr Stewart assured you that the reclassification of these unpresented cheques back to trade payables was not warranted since the company's current ratio was well within the covenant limits.

Your assessment about Assertion 2: Cash transactions have been recorded in the proper period.						
1	2	3	4	5	6	7
Strongly believe that the assertion is NOT true						Strongly believe that the assertion is true

To verify Assertion 3 (Accuracy):

You were comparing paid cheques recorded in the cash payments journal with cheques cleared by the bank as listed in the bank statement. There was one cheque which was cleared by the bank for the value $2,222,222.00. The same cheque was recorded as $222,222.00 in the cash payments journal. You discussed this with Mr Stewart, the Financial Controller, who assured you that this must be another bank error and he would request that the bank correct their mistake immediately.

Your assessment about Assertion 3: Cash transactions have been recorded using the proper amounts.						
1	2	3	4	5	6	7
Strongly believe that the assertion is NOT true						Strongly believe that the assertion is true

To verify Overall Assertion

Your assessments about this overall assertion: The cash transactions have been recorded fairly.						
1	2	3	4	5	6	7
Strongly believe that the assertion is NOT true						Strongly believe that the assertion is true

To verify Overall Assertion

Your assessments about this overall assertion: The cash and cash equivalent balance on the 2008 balance sheet is fairly presented.						
1	2	3	4	5	6	7
Strongly believe that the assertion is NOT true						Strongly believe that the assertion is true

PLEASE DO NOT CHANGE YOUR ANSWER ONCE YOU PROCEED TO THE NEXT SECTION.

New Additional Information

You audited a sample of non-inventory transactions in the cash payments journal. You discovered that one of the travel expenditures paid by Telcom was for airfares to Hawaii for Mr Stewart and his family. The expenditure had been approved only by Mr Stewart. You pointed this out to Mr. Stewart. Nevertheless, there was no adjustment made with respect to this personal payment.

Mr Stewart was recently honoured with the prestigious CFO of the Year Award. This award is presented annually to an outstanding CFO who has demonstrated, to an independent panel, outstanding levels of achievements across six professional attributes including a high technical competence in corporate accounting and financial reporting.

Please state your assessment on whether the assertions are true or false based on the background information, audit evidence, and the new additional information provided above. Please make the assessments of the audit assertions independently. Again, you should take into consideration only audit evidence regarding that particular audit assertion and the background information.

To verify Assertion 1 (Completeness):

Your revised assessment about Assertion 1: All cash transactions have been recorded.						
1	2	3	4	5	6	7
Strongly believe that the assertion is NOT true						Strongly believe that the assertion is true

To verify Assertion 2 (Cut-off):

Your revised assessment about Assertion 2: Cash transactions have been recorded in the proper period.						
1	2	3	4	5	6	7
Strongly believe that the assertion is NOT true						Strongly believe that the assertion is true

To verify Assertion 3 (Accuracy):

Your revised assessment about Assertion 3: Cash transactions have been recorded using the proper amounts.						
1	2	3	4	5	6	7
Strongly believe that the assertion is NOT true						Strongly believe that the assertion is true

To verify Overall Assertion

Your revised assessments about this overall assertion: The cash transactions have been recorded fairly.						
1	2	3	4	5	6	7
Strongly believe that the assertion is NOT true						Strongly believe that the assertion is true

To verify Overall Assertion

Your revised assessments about this overall assertion: The cash and cash equivalent balance on the 2008 balance sheet is fairly presented.						
1	2	3	4	5	6	7
Strongly believe that the assertion is NOT true						Strongly believe that the assertion is true

Part 3: Debriefing Questions

Question Set 1: Additional Questions.

1. Please assess the level of honesty of the Financial Controller.

1	2	3	4	5	6	7
Dishonest			Moderately Honest			Honest

2. Please assess the level of competency of the Financial Controller.

1	2	3	4	5	6	7
Incompetent			Moderately Competent			Competent

Question Set 2: Information on yourself.

1. What is your gender? Please tick
   Male ☐ Female ☐

2. How old are you?
   ______________ years

3. How many years of audit-related experience do you have?
   ______________ years

4. What is your current position? Please tick ONE box only
   Audit Staff ☐
   Senior Auditor ☐
   Audit Manager ☐
   Audit Partner ☐
   Internal Auditor ☐
   Audit Committee Member ☐
   Other ☐
   Please specify ______________________________

5. Which type of firm are you working for? Please tick ONE box only
   Big-4 Firm ☐
   Medium Size Firm ☐
   Small Firm ☐
   Other ☐
   Please specify ______________________________

6. Have you ever worked for any of the following firms? Please tick the relevant box(es).
   Big-4 Firm ☐
   Medium Size Firm ☐
   Small Firm ☐
   Other ☐
   Please specify ______________________________

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